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Accounting and auditing update handbook

American Institute of Certified Public Accountants

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Foreword

In planning this first edition of the *Accounting and Auditing Update Handbook*, our aim was to create a compact, portable manual that would serve as a reference guide to the accounting and auditing authoritative pronouncements issued recently to serve practitioners in both public and private practice in their many engagements requiring application of these new rules. In preparing this book, we concentrated on making it highly practical and readily accessible.

The material presented is based on the outlines for the AICPA Continuing Professional Education two-day Accounting and Auditing update workshop, and, accordingly, covers

- Accounting Standards
- Auditing Standards
- Compilation and Review Standards
- Standards for other Accounting and Auditing services.

Throughout the analysis, emphasis is placed on application of the new rules, and we include text cases and solutions to highlight specific practice problems. The text is broken down into chapter-by-chapter section designation. The index terminology at the back of the volume is referenced to chapter titles and their corresponding section numbers. Part I is devoted to a discussion of accounting. Its chapters are—

1. Accounting for Income Taxes—SFAS No. 96
2. Accounting for Cash Flows—SFAS No. 95
3. Accounting for Pensions—SFAS No. 87

4. Accounting for Consolidations—SFAS No. 94
5. Accounting for Loan Origination Fees—SFAS No. 91
6. The FASB Emerging Issues Task Force—review of activity
7. Overview of Other Statements and Technical Bulletins

Part II is devoted to a discussion of auditing and compilation and review standards. We offer a discussion of the nine new "expectation gap" SASs intended to close the gap between public expectations and auditor responsibilities. Also included in Part II is coverage of compliance auditing and the attestation standard for pro forma financial information.

8. Errors, Irregularities, and Illegal Acts
9. Internal Control Structure
10. Improving Audit Effectiveness
11. Auditor Communications
12. Pro Forma Financial Information
13. Compliance Auditing

The *Accounting and Auditing Update Handbook* is intended to be an important annual review of professional literature that will aid and supplement practitioner study and use of authoritative pronouncements. Practitioners are also encouraged to enroll in the CPE Accounting and Auditing Update Workshops scheduled annually throughout summer and fall. Presentations for the 1989-90 CPE year will be held June 1 through December 31, 1989. This volume summarizes the material presented in the course and can serve as a portable compendium.

We would like to acknowledge all those who contributed to the preparation of the *Accounting and Auditing Update Handbook*. In particular, we express our gratitude to Professor Joseph E. Lane, Jr., Professor Emeritus of accounting at the University of Alabama and to Professor Raymond O. Wittington, Professor of Accounting at the University of California, San Diego, who reviewed the text of this volume.

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CHAPTER 1

Accounting for Income Taxes

(FASB Statement No. 96)

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Accounting for Income Taxes

(FASB Statement No. 96)

Issued in December 1987 by the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 96, entitled *Accounting for Income Taxes*, retains the comprehensive allocation objective of Accounting Principles Board (APB) Opinion No. 11, *Accounting for Income Taxes*, as well as the exceptions in APB 23, *Accounting for Income Taxes—Special Areas*. However, SFAS 96 replaces the deferred approach with the asset and liability approach—that is, deferred taxes are viewed either as assets or liabilities—and accordingly modifies the accounting for deferred income taxes consistent with that view:

- Deferred taxes are computed separately for each taxing jurisdiction, and receivables from or payables to different jurisdictions are not offset.
- The effects of changes in tax laws, tax rates, or the tax status of an entity are recognized either when the law is enacted or when the tax status of the entity changes.
- Tax-planning strategies are used to reduce a deferred tax liability or to increase a deferred tax asset by altering the period in which temporary differences reverse.
- Deferred tax assets arising from temporary differences are recognized only through carrybacks to taxes paid in the current or prior years, or through carryforwards to future years to offset deferred tax liabilities that will reverse during the carryforward period.
- Deferred tax assets and liabilities are recognized on temporary differences in business combinations.
- Deferred tax assets and liabilities are classified as current or noncurrent based on the period of reversal rather than on the nature of the transaction giving rise to the temporary difference.

SFAS 96 is effective for fiscal years beginning on or after December 15, 1988, although the FASB has recently amended the Statement, by

SFAS No. 100, entitled *Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*, which postpones the effective date to fiscal years beginning after December 15, 1989.

1. SCOPE OF SFAS 96

SFAS 96 establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The Statement continues the fundamental requirements of comprehensive tax allocation, with modifications, and supersedes the following:

- APB 11
- APB Opinion No. 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other Than Subsidiaries and Corporate Joint Ventures)*
- FASB Statement No. 37, *Balance Sheet Classification of Deferred Taxes*
- Numerous related FASB Interpretations (FAS Is) and Technical Bulletins (TBs)

SFAS 96 also amends numerous Accounting Research Bulletins (ARBs), APB Opinions, and FASB Statements that incorporate references to income tax accounting. (See Appendix D of SFAS 96 for details.) The list of affected Statements is rather extensive because of the pervasive effects of income taxes on an enterprise's transactions and accounts. Among those Statements that are significantly affected is APB Opinion No. 16, *Business Combinations*.

The only exceptions to comprehensive tax allocation are those discussed in APB 23, which SFAS 96 did not amend. These exceptions are—

- Undistributed earnings of subsidiaries.
- Bad debt reserves of savings and loan associations.
- Policyholders' surplus of stock life insurance companies.

The exceptions in APB 23 were retained because of perceived complexities of measurement in the case of undistributed earnings and uniform application of other existing exceptions in APB 23.

In addition, SFAS 96 does not amend accounting for leveraged leases as required by both SFAS 13, *Accounting for Leases*, and FAS I 21, *Accounting for Leases in a Business Combination*. Nor does the Statement address the recognition of deferred taxes for deposits in statutory reserve funds by U.S. steamship enterprises, and it prohibits recognition of a deferred tax liability for assets related to goodwill.

SFAS 96 establishes financial accounting and reporting standards for income taxes that are currently payable as well as for the tax consequences of (a) revenues, expenses, gains, and losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income, (b) other transactions that create differences between the tax bases of assets and liabilities, and their amounts for financial reporting, and (c) operating loss or tax credit carrybacks and carryforwards.

The requirements of SFAS 96 are applicable to—

- Domestic federal income taxes (U.S. federal income taxes for U.S. enterprises) and to foreign, state, and local taxes (including franchises), based on income.
- An enterprise's foreign operations that are consolidated, combined, or accounted for by the equity method.
- Foreign enterprises for purposes of preparing financial statements in accordance with U.S. generally accepted accounting principles (GAAP).

As indicated earlier, SFAS 96 continues the requirement of comprehensive tax allocation—that is, the recognition of the tax effects of transactions in the same year in which the transaction is recognized for financial reporting. In general, the Statement does not change the accounting for the investment tax credit (ITC), intercompany tax allocation, interim reporting, the proscription of discounting, and APB 23 exceptions to tax allocation.

The deferral and flow-through methods continue to be acceptable alternatives in accounting for the ITC. However, note that the Tax Reform Act of 1986 repealed the ITC and limits the use of credits of prior periods that are carried forward.

SFAS 96 does not prescribe any single method for recognizing and measuring income taxes in the separately issued financial statements of an entity that is part of a group filing consolidated returns. However, it does add certain disclosure requirements, which will be discussed later.

Most of the provisions of APB Opinion No. 28, *Interim Reporting*, continue in effect, except that the discrete approach is now required in implementing the effects of tax law changes. The entire effect of a change in tax rates must be recognized in the interim period of enactment.

The proscription of discounting under APB Opinion No. 10, *Omni-*

bus Opinion—1966, continues in force. The extension of that proscription to business combinations, via the new approach to tax allocation, means that it no longer will be acceptable to discount the tax effects of fair value (book)/tax differences that arise in connection with purchase business combinations.

2. BASIC PRINCIPLES

SFAS 96 adopts the liability and asset approach to income tax allocation in place of the deferred approach in APB 11. (A detailed comparison of the two approaches appears in Appendix A.) Both approaches represent applications of comprehensive tax allocation, with the exceptions noted above. But there are important differences in application that would yield different results in all but the simplest of cases.

2.1 Liability and Asset Approach

Under SFAS 96, the amount of the liability or asset for deferred taxes arising from temporary differences, including timing differences, is computed as though a tax return were prepared for the net amount of temporary differences, resulting in taxable or deductible amounts in each future year. A temporary difference is the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years, when the reported amount is either recovered or settled. Thus, such originating differences as depreciation, which give rise to deferred tax liabilities, represent taxable amounts in future years' tax returns since they are scheduled to reverse. It is assumed that the assets' costs will be recovered on a break-even basis. This method does not anticipate the tax consequences of earning income or incurring losses in future years. Originating differences such as warranties expense or unearned income give rise to future deductible amounts when they reverse and the costs are incurred. Again, no future earnings or losses are anticipated. A current and/or deferred tax liability or asset is recognized for the current and deferred tax consequences of all events that have been recognized in the financial statements. The income statement provision for deferred taxes is based on the year-to-year change in the balance-sheet amounts for deferred taxes. When the change in deferred taxes is either added to or subtracted from the provision for current taxes, the result is the income tax expense for the years.

Consistent with the liability and asset approach, SFAS 96 calls for current and noncurrent classification, which is based on the timing of the expected reversal rather than on the classification of the related asset or liability, which would give rise to the temporary difference. Additionally, the effects of a change in tax rate, tax law, or an entity's tax status on existing deferred tax liabilities and assets should be recognized either when the law is enacted or when the entity's status changes. The Statement further modifies the accounting rules for net operating loss (NOL) carryforwards.

2.2 Temporary Differences

Temporary differences include those items previously classified as timing differences, but with an emphasis now on the accrual of the appropriate balance-sheet deferred tax amounts. For example—

- Revenues or gains taxable after they are recognized in financial income. (A receivable from an installment sale will result in taxable amounts when collected.)
- Expenses or losses deductible after they are recognized in financial income. (A product warranty liability will result in tax deductible amounts when the liability is settled.)
- Revenues or gains taxable before they are recognized in financial income. (Subscriptions received in advance necessitate the recognition of a liability; future sacrifices to provide goods or services to settle the liability will result in tax deductible amounts in a future year.)
- Expenses or losses deductible before they are recognized in financial income. (In the case of depreciation differences, amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis, resulting in taxable income.)
- A reduction in the tax basis of depreciable assets due to tax credits (that is, taking the full ITC and reducing the ACRS deduction).
- ITC accounted for by the deferred method.
- Other tax basis adjustments.
- Foreign operations for which the reporting currency is the functional currency. After a change in exchange rates, there will be a difference between the foreign tax basis and the foreign currency equivalent of the U.S. dollar historical cost of those assets and liabilities. The difference will be taxable or deductible for foreign taxes when the assets or liabilities are either recovered or settled.

Temporary differences also include differences between the accounting and tax basis of assets acquired in a business combination that is accounted for as a purchase. Previously, such differences were accounted for on a net-of-tax basis and treated as permanent differences.

Temporary differences not identified with a particular asset or liability for financial reporting include the following:

- Long-term contracts that use percentage-of-completion reporting for book purposes and the completed contract basis for tax.
- Organization costs that are written off for book purposes but amortized for tax.

In these cases, there is an asset or liability for tax purposes but none for financial reporting. These temporary differences will result in taxable or deductible amounts in future years.

The amount actually recovered for a particular asset or paid to settle a particular liability in a subsequent year may be different from the amount recognized for financial reporting in the current year. The change in tax consequences resulting from the gain or loss is recognized when the gain or loss is recognized.

Some events do not have tax consequences. For example, interest on municipal obligations is not taxable. Such items are classified as permanent differences in APB 11; SFAS 96 does not discuss permanent differences.

2.3 Recognition

SFAS 96 requires that a liability or asset be recognized for the deferred tax consequences of all temporary differences, except for those differences related to indefinite reversals (see APB 23). (SFAS 96 eliminates the "with" and "without" approach as well as the use of gross change or net change methods.) The recognition and measurement process is governed by the following provisions:

- The measurement of a deferred tax liability or asset assumes that the only taxable or deductible amounts in future years are the result of temporary differences at the end of the current year.
- Future recovery of assets and settlement of liabilities at their reported amounts are assumed events and result in taxable or deductible amounts.
- Recognition and measurement of taxable effects ignore the tax con-

sequences of earnings or losses in future years. These are future events and are not anticipated, regardless of probability for purposes of accounting for income taxes.

- A deferred tax expense or benefit should be recognized for the net change during the year in an enterprise's deferred tax liability or asset accounts. That amount, together with income taxes currently payable or refundable, is the total amount of income tax expense or benefit for the year.

The following procedures are applied separately for each tax jurisdiction:

- Estimate the particular future years in which temporary differences will result in taxable or deductible amounts.
- Determine the net taxable or deductible amount in each future year.
- Deduct operating loss carryforwards for tax purposes from net taxable amounts that are scheduled to occur in those future years included in the loss carryforward period.
- Carry back or carry forward, as permitted or required by law, net deductible amounts occurring in particular years to offset net taxable amounts that are scheduled to occur in prior or subsequent years.

Depending upon the circumstances, the result of these steps will result in the recognition of either a deferred tax asset or a deferred tax liability.

2.4 Deferred Tax Asset

A deferred tax asset for the tax benefit of net deductible amounts is recognized if it can be realized by loss carryback from future years to reduce (a) a current deferred tax liability or (b) taxes paid in either the current or a prior year.

No asset is recognized for any additional net deductible amounts in future years. These amounts are, in substance, the same as operating loss carryforwards.

2.5 Deferred Tax Liability

If the above steps result in net taxable amounts, then the following procedures would be required:

- Calculate the amount of tax for the remaining net taxable amounts scheduled to occur in each future year, applying the laws and rates for each of those years to the type and amount of net taxable amounts scheduled for those years.

- Deduct tax credit carryforwards for tax purposes, as permitted or required by law, from the amount of tax for future years included in the carryforward periods.
- Recognize a deferred tax liability for the remaining amount of taxes payable for each future year.

2.6 Reduction of Scheduling

To reduce the amount of scheduling and detailed calculations otherwise called for, identify a company's temporary differences and determine for each whether the tax law precludes or effectively precludes tax-planning strategies, which could alter the years in which temporary differences fall. (Tax-planning strategies required under SFAS 96 are discussed below.) For such temporary differences, scheduling is required. For others, determine whether there is a strategy that meets the criteria of SFAS 96; if so, such differences may be offset for deferred tax calculations.

Note: Deferred tax computations must be done by ascending year and follow the ordering rules permitted or required by existing relevant tax law that relate to carrybacks and carryforwards.

2.7 Offset of Taxable and Deductible Amounts

If the tax law states that capital losses or other items are deductible only to the extent of capital gains or other items, then temporary differences resulting in future deductions in the form of capital losses or other items cannot be offset against temporary differences that will result in future ordinary income.

2.8 Pattern of Taxable or Deductible Amounts

The particular years in which temporary differences will result in taxable or deductible amounts is determined by referring to the timing either of the recovery of the related asset or of the settlement of the related liability. Estimates may be required, including the following examples:

- Estimated liability for some product warranties may be settled over a period of several years.
- LIFO inventory differences will result in taxable or deductible amounts when the reported amount of inventory is recovered. Future recovery is assumed; however, future purchases or inventory production are not assumed.

  Note: The reported amount of LIFO inventory would be recoverable next year if inventory is estimated to "turn over" at least once a year. On that basis, a temporary difference for LIFO inventory would be considered taxable or deductible next year.

- Other temporary differences, such as those related to depreciable assets, may accumulate over several years and then be eliminated over several years. Future temporary differences for existing depreciable assets in use should be considered in determining the future years in which existing temporary differences result in net taxable or deductible amounts.
- SFAS 96 permits offsetting those future reversals arising from one natural aggregation of depreciable assets against future accumulations arising from another natural aggregation of depreciable assets.

It is important to note that consideration of such future originating differences may affect the following:

- Measurement of deferred taxes when enacted tax rates differ for different years
- Recognition of a tax benefit for other temporary differences that will result in deductible amounts in future years
- Classification of deferred tax liabilities or assets in a statement of financial position

On pages 12–15 is a tabular summary of selected accounts including a description of the nature of book and tax bases differences and identification of each difference as either a taxable or deductible amount. The table describes the approach to scheduling future taxable or deductible amounts for these differences.

Temporary Differences—Identifying and Scheduling Future Taxable and Deductible Amounts

		Book Basis Exceeds Tax Basis		Tax Basis Exceeds Book Basis		
Account	*Book and Tax Bases Differences*	*Assets (Taxable)*	*Liability (Deductible)*	*Asset (Deductible)*	*Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
Accrued expenses and estimated losses (discontinued operations, warranties, litigation)	Accrual basis for books, cash basis for tax purposes		✓			Schedule as deductible amount in year(s) that amounts will be deducted for tax purposes. For warranties consider terms as well as historical experience.
Allowance for doubtful accounts	Allowance method for books, specific charge-off method for tax purposes (TRA 1986)		✓			Schedule based on estimates of future specific charge-offs or historical experience based on aging schedule.
	IRC Section 481 for change in tax accounting				✓	The existing allowance at the beginning of 1987 is "deferred income" for tax purposes to be taken into taxable income over 4 years. The account has a zero accounting basis resulting in taxable amounts.
Deferred intercompany profit in inventory	Tax basis of inventory will exceed consolidated financial statement basis by the amount deferred			✓		Schedule as a deductible amount in year(s) the profit will be recognized for financial reporting.

Intangible assets (except goodwill)	Faster write-off for tax than for books	✓			Schedule over years of reversal based on planned systematic amortization.
	Allocated values in business combination, tax basis exceeds book basis (assume amortizable for tax purposes)		✓		Schedule over years of reversal based on planned systematic amortization.
Inventory	Allowance for obsolescence for books only		✓		Schedule in year(s) the inventory will be disposed of and loss realized.
	Additional costs capitalized for tax only (uniform rules)		✓		Scheduled based on turnover of physical inventory (one year or operating cycle).
	Excess of current value over LIFO in business combination	✓			Schedule based on turnover of physical inventory (one year or operating cycle).
	IRC Section 481 adjustments for change in tax accounting			✓	Adjustments for capitalization as of January 1987 are taken into taxable income over 4 years. There are, however, accelerating provisions in the tax law. The deferred income has a zero basis for book purposes.
Investments in marketable securities (short-term)	Lower of cost or market for books, cost for tax		✓		Schedule for the year following the balance sheet date. If item is a capital loss, not deductible against ordinary income, then do not include with other amounts subject to ordinary income effects.

Temporary Differences—Identifying and Scheduling Future Taxable and Deductible Amounts

		Book Basis Exceeds Tax Basis		*Tax Basis Exceeds Book Basis*		
Account	*Book and Tax Bases Differences*	*Assets (Taxable)*	*Liability (Deductible)*	*Asset (Deductible)*	*Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
Investments in stock of other companies—20%-50% owned	Equity method for books, cost method for tax purposes (assume investee's profits exceed dividends)	✓				Schedule the difference in the year the investor plans to sell the investment, unless realization is expected to occur in the form of dividends. Deferred tax must be provided because it does not fall under the APB 23 exception.
Land	Valuation assigned in business combination exceeds tax basis	✓				Assigned to year of expected disposal. If no such plans, assign to a distant period.
Leased fixed assets (plant, equipment)	Capital lease for books, operating lease for tax purposes					Schedule on basis of amortization of the asset.
	Leased asset (zero tax basis)	✓				Schedule on basis of planned systematic depreciation.
	Lease liability (zero tax basis)		✓			Schedule based on amortization of principal or based on the present value of future cash flows.
Lease receivable	Direct financing or sales-type lease for books, operating lease for tax purposes					

	Leased asset (zero book basis)			✓	Schedule on basis of planned systematic depreciation.
	Lease receivable (zero tax basis)	✓			Schedule on basis of amortization of principal or present value of future cash flows.
Notes receivable	Accrual basis for books, installment method for tax purposes	✓			Schedule deferred profit on installment sales on a recovery basis.
Pension costs	Pension asset (excess funding [expensing] for tax over book expense)	✓			Schedule based on future years' pension expense for book purposes
	Pension liability (book expense exceeds tax funding [expensing])		✓		Schedule based on estimated future deductible contributions measured on a present value basis.
Plant and equipment	Faster write-off for tax than book	✓			Schedule on basis of pattern of depreciation differences between book and tax including originating as well as reversing differences.
	Capitalize items for book, write-off for tax	✓			Schedule on basis of book depreciation.
Prepaid expenses	Defer for book, write-off for tax	✓			Schedule as expenses are to be recognized.
Unearned income	Accrual basis for book, cash basis for tax purposes		✓		Schedule based on periods in which income will be earned.

2.8.1 Implementation Guidance on Taxable or Deductible Amounts

Scheduling estimates. Certain temporary differences, such as those arising from allowances for obsolete inventory, loan losses, or unrealized gains or losses on long-term investments in marketable equity securities, require estimates for scheduling. On the other hand, unrealized losses on short-term marketable equity securities are assumed to result in deductible amounts on the first day of the next period. SFAS 96 prohibits anticipating future gains or losses.

Present values. Scheduling the pattern of taxable or deductible amounts when assets and liabilities are measured at present values poses special problems, for which solutions depend on whether or not the asset or liability book basis is more or less than the tax basis. If it is more, each future cash receipt or cash payment may first be allocated to interest, with the remainder considered a recovery or settlement of a temporary difference. An alternative approach is to base the scheduling pattern on the present value of each future cash receipt or cash payment. However, if the tax basis exceeds the book basis on a present-value basis, the temporary difference will result in a taxable or deductible amount either on the first day of the next period or according to the alternative approach discussed above.

Lessor. If a lessor accounts for a lease as a direct financing lease for financial reporting, but treats the lease as an operating lease for tax purposes, two temporary differences are involved. One relates to the investment in the lease, which has a zero tax basis. The other difference relates to the leased asset for tax purposes, which has a zero book basis. For the investment in the lease for book purposes, the pattern of taxable amounts should follow the steps used above for situations where book basis exceeds tax basis. In the case of the temporary differences related to the leased asset for tax purposes, the scheduling would follow the depreciation pattern.

In addition, accounting for pension costs may give rise to temporary differences that require the recognition of present values in dealing with the asset or liability.

Inventory cost capitalization. The Tax Reform Act of 1986 adopted uniform capitalization rules for inventory that require capitalizing costs for tax purposes expensed for financial reporting. This requirement gives rise to a temporary difference that would result in a deductible amount when the inventory is sold. The other difference results from the catch-up adjustment, which will be included in taxable income over four years.

Intercompany profits. Intercompany profit on a transfer between companies of inventory or other assets that are not included in the consolidated tax return results in temporary differences. Determination of whether or not to recognize a tax benefit as well as the amount of the benefit should be based on the tax circumstances of the *acquiring*, not the *selling*, company. The temporary difference will result in a deductible amount on the acquiring company's tax return in a future year in which the cost of the inventory, as reported in the consolidated financial statements, will be recovered.

Intercompany profit—foreign subsidiary. If exchange rates subsequently change and the U.S. dollar is the functional currency, the deferred tax benefit for intercompany profits, resulting from a transfer of inventory or other assets from a U.S. parent company to a foreign subsidiary, should be determined in accordance with the illustration following paragraph 43 in SFAS 96 as well as the criteria for recognition of deferred tax benefits.

However, if the foreign currency is the functional currency and the intercompany profit is translated at the historical exchange rate, the deferred tax benefit attributable to that temporary difference, if recognizable, will not change if exchange rates subsequently change.

2.9 Measurement of Deferred Tax Liability or Asset

A deferred tax liability or asset at each balance-sheet date is computed by applying tax law provisions to measure the tax consequences of temporary differences that will result in net taxable or deductible amounts in each future year, based on—

- Elections and options expected to be made for tax purposes in future years.
- Enacted changes in tax laws or rates scheduled for a particular future year or years and applied to differences arising in that year or years.

Tax laws and rates of the current year are used if no changes have been enacted for future years. Tax laws and rates of the current or a prior year are used for net tax deductible amounts that will be realized based on carryback provisions.

A deferred tax liability is measured using tax rates applicable to such items as capital gains and ordinary income. For example—

- Facts and circumstances would dictate whether deferred tax on the equity in an investee's earnings should be measured as a capital gain or as a dividend.
- A consistent policy of selling depreciable assets might indicate that capital gain rates are more appropriate to measure deferred tax for differences between tax and book basis.

Carryback. Several points need to be emphasized with respect to recognition and measurement.

If a tax benefit for temporary differences that will result in deductible amounts in future years is recognized either by reducing a deferred tax liability or by recognizing a deferred tax asset, the tax rate to be used is the rate of the carryback period, despite the different rates that have been enacted for the years in which the deductible amount will be realized. The basis for this approach is that SFAS 96 prohibits anticipation of the tax consequences of incurring losses or generating profits in future years. Furthermore, the probability that the benefits will be realized at a lesser amount does not give rise to a loss contingency. Future realization of the tax benefit at a lower rate would be the sole consequence of generating profits in the later years. Those future profits are *causal* events rather than *confirming* events.

2.9.1 Case Applications in Scheduling and Measurement

The following five cases illustrate the application of scheduling and the procedures called for by SFAS 96 to determine deferred income taxes.

Case 1. Illustration of deferred tax liability

AB Corporation

AB Corporation's tax reconciliation in Year 1 is as follows:	
Pretax financial income	$ 2,000
Estimated expenses, deductible when paid	2,600
Excess tax depreciation over book depreciation	(3,000)
Taxable income	$ 1,600

Assume estimated expense will be settled in Year 5.

Depreciation differences will result in taxable amounts of $600 per year for Years 2 through 6.

Tax rate: 40 percent for all years.

As indicated in Exhibit 1-1, the determination of deferred income tax for Year 1 would require the carryback of the net deductible amount in Year 5 and the carryforward of the balance to Year 6.

The deferred tax liability of $160 is segregated into a current liability of $240 and a noncurrent assset of $80. This classification is required because the $600 deductible, carried back to Year 2, will not be realized until Year 5. Therefore, the $600 taxable amount in Year 2 calls for the recognition of a current deferred tax liability. The deductible amount of $600, carried back, would then be freed-up to offset the $400 net taxable amount in Year 6, resulting in a net deductible amount of $200 in that year and giving rise to a noncurrent deferred tax asset.

Exhibit 1-1 *AB Corporation*
Scheduling of Taxable and Deductible Amounts

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Taxable income	$1,600					
Taxable amounts		$ 600	$ 600	$ 600	$ 600	$ 600
Deductible amount					(2,600)	
	1,600	600	600	600	(2,000)	600
Carryback		(600)	(600)	(600)	1,800	
Carryforward					200	(200)
	$1,600	0	0	0	0	$ 400

Journal Entries

Current tax expense	$640	
Tax payable ($1,600 × 40%)		$640
Deferred tax expense	160	
Deferred tax liability ($400 × 40%)		160

Income Statement Presentation

Current tax provision	$640
Increase in deferred income tax	160
Income tax expense	$800

The deferred tax liability of $160 would be classified as follows:

Deferred tax liability—current $240. ($600 × 40 percent)
Deferred tax asset—noncurrent $80. ($200 × 40 percent)

Case 2. Illustration of deferred tax assets and unused deductible amount

BC Corporation

BC Corporation's tax reconciliation in Year 1 is as follows:	
Pretax financial loss	$ (200)
Estimated expense, deductible when paid	4,000
Excess of tax depreciation over book depreciation	(2,400)
Taxable income	$ 1,400

Assume that the estimated expense is for litigation and will be deductible when paid in Year 4. The depreciation differences will result in taxable amounts of $600 in each of Years 2 to 5. Also assume a tax rate of 40 percent for all years.

The determination of the deferred income tax for Year 1 requires scheduling as in Exhibit 1-2. The $3,400 net deductible amount in Year 4

Exhibit 1-2 *BC Corporation*
Scheduling of Temporary Differences

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Taxable income	$1,400				
Taxable amounts (Depreciation)		$ 600	$ 600	$ 600	$ 600
Deductible amount (Estimated losses)				(4,000)	
	1,400	600	600	(3,400)	600
Carryback	(1,400)	(600)	(600)	2,600	
Carryforward				600	(600)
Loss carryforward	0	0	0	$(200)	0

Journal Entries for Year 1:

Current income tax expense	$560	
Taxes payable ($1,400 × 40 percent) (To record current tax payable)		$560
Deferred tax asset	$560	
Deferred tax expense (To record change in deferred tax)		$560

Income Statement Presentation
Provision for income taxes:

Current income tax	$560
Less increase in deferred tax asset	560
	0

is carried back to Years 1 to 3 and forward to Year 5, which in effect eliminates any income tax expense. The current tax expense of $560 is, therefore, offset by an increase in a deferred tax asset in the same amount.

Note: The $200 loss carryforward in Year 4 does not result in recognition of a deferred tax asset and is treated in the same way as an operating loss carryforward.

For balance-sheet purposes, the deferred tax asset of $560 is classified as follows:

Deferred tax liability—current	$240
Deferred tax asset—noncurrent	$800

For an underlying explanation, refer back to Case 1.

Case 3. Illustration of deferred tax liability—current and noncurrent

CD Corporation

CD Corporation's only temporary differences at December 31, 19X6, consist of the following:

- $60,000 excess of tax depreciation over financial statement depreciation. Taxable amounts from 19X7 to 19X9: $30,000, $20,000, $10,000
- $20,000 reserve for litigation expected to be deductible in 19X9

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

There were no taxes in period 19X6 or prior; carryback of three years is permitted.

The deferred tax amounts would be determined as in Exhibit 1-3.

Note that the carryback benefit is at 40 percent, the 19X7 rate. The $4,000 deferred tax asset is noncurrent because it will be realized in 19X9.

The reversal of $30,000 in 19X7 gives rise to a current liability.

The deferred tax provision would be based on the year-to-year change in balance-sheet deferred tax accounts.

Exhibit 1-3 *CD Corporation*

	Balance 12/31/X6	*Taxable 19X7*	*(Deductible) 19X8*	*Reversals 19X9*
Depreciation	$ 60,000	$ 30,000	$20,000	$ 10,000
Litigation reserve	(20,000)			(20,000)
	$ 40,000	$ 30,000	$20,000	(10,000)
Carryback		(10,000)		(10,000)
		$ 20,000	$ 20,000	$ 0

Deferred tax liability—current	($30,000 @ 40%)	$12,000
Deferred tax liability—noncurrent	($20,000 @ 34%)	$ 6,800*
Deferred tax asset—noncurrent	($10,000 @ 40%)	$ 4,000*

*$2,800 would be shown as net noncurrent deferred liability.

Case 4. Illustration of NOL carryforward

DE Corporation

DE Corporation's only temporary differences at December 31, 19X6, consist of the following:

- $60,000 excess of tax depreciation over financial statement depreciation. Reversing, 19X7 to 19X9 at $30,000, $20,000, $10,000
- $20,000 reserve for litigation *expected* to be deductible in 19X9

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

No tax was paid in 19X6 or prior years; the enterprise has an NOL carryforward of $30,000 from 19X5. The taxing jurisdiction provides for three-year carryback and fifteen-year carryforward of NOLs.

An analysis of taxable and deductible amounts and the determination of deferred taxes for the year appear in Exhibit 1-4. Note that the NOL carryforward is scheduled before any carryback or carryforward of net deductible amounts.

Exhibit 1-4 *DE Corporation*

	Balance 12/31/X6	*Taxable 19X7*	*(Deductible) 19X8*	*Reversals 19X9*
Depreciation	$ 60,000	$30,000	$ 20,000	$ 10,000
Litigation reserve	(20,000)			(20,000)
	$ 40,000	$30,000	$ 20,000	(10,000)
NOL carryforward (C/F)		(30,000)		
Tax deduction carryback (C/B)		0	(10,000)	10,000
		$ 0	$ 10,000	$ 0

At December 31, 19X6, the DE Corporation would have a noncurrent deferred tax liability of $3,400 ($10,000 × 34%).

Case 5. Illustration of originating and reversing differences

EF Corporation

In EF Corporation's first year of operations, it has pretax financial income of $1,400, taxable income of $1,000, and taxes payable—current of $400 (40-percent rate).

Temporary differences in Year 1 are:

Installment sale difference (taxable in Year 2)	$600
Depreciation difference—net*	200
Estimated expense (deductible in Year 7)	(400)
	$400

*Future recovery of depreciation differences is as follows:

Year 2	$1,800	deductible
Year 3	1,200	taxable
Year 4	800	taxable

Tax rates: Year 1—40 percent; Years 2 to 4—30 percent.

The analysis in Exhibit 1-5 shows that the originating difference in Year 2, which gives rise to a net deductible amount of $1,200, is carried back as well as forward.

The net result is a current tax provision of $400 and a deferred tax provision of $20:

Current tax provision ($1,000 × 40 percent)	$400
Deferred tax provision ($420 − $400)	20
Total income tax expense	$420

Note that under APB 11, the tax provision would have been $1,400 × 40% = $560. The deferred tax liability would have been $160.

Under SFAS 96, the lower tax rates in Years 3 and 4 reduce that balance by $140 ($1,400 × 10%).

Exhibit 1-5 *EF Corporation*
Schedule of Temporary Differences

	Current		*Future Years*		
	Year	*Year 2*	*Year 3*	*Year 4*	*Year 7*
Taxable income	$ 1,000	$ —	$ —	$ —	$ —
Temporary differences					
Installment sales		600			
Depreciation		(1,800)	1,200	800	
Estimated expenses					(400)
	$ 1,000	(1,200)	1,200	800	(400)
Loss carryback (C/B)	(1,000)	1,000		(400)	400
Loss carryforward (C/F)		200	(200)		
	$(1,000)	$ —	$ 1,000	$400	$ —
Tax rate	40%		30%	30%	
Deferred tax liability					
(asset) current	$ (400)				
noncurrent			$ 300	$ 120	

2.10 Tax-Planning Strategies

Under SFAS 96, the annual computation of a deferred tax liability or asset may be affected by tax-planning strategies that determine the years in which temporary differences will result in taxable or deductible amounts. The Statement requires tax planning under which—

- Amounts may become deductible in a different year and provide a tax benefit by offsetting taxable amounts as a carryback or carryforward, or by recognizing a deferred tax asset by loss carryback.

- Amounts may become taxable in a different year before a loss or tax credit carryforward expires, or in a particular year that maximizes the benefit of tax credits.

Tax-planning strategies that would change the future years in which temporary differences result in taxable or deductible amounts may be taken into account if they meet the following tests:

- The deferred tax consequences must be recognized at the balance-sheet date.
- The strategy must be prudent, feasible, and permitted by tax law, and management must have the discretion, control, ability, and intent to implement the strategy, if necessary, to reduce taxes. Management does not need to carry out the strategy in the future if income earned in a following year permits realization of the entire tax benefit of a loss or tax credit carryforward from the current year.
- The strategy must not involve significant cost to the enterprise. The tax benefit derived from the strategy is not to be viewed as a cost reduction.

The following actions primarily involve accelerating or delaying the recovery of an asset, or the settlement of a liability to minimize taxes.

- Some tax-planning strategies permit the recognition of a tax benefit for operating loss and tax credit carryforwards by accelerating taxable amounts to years before the carryforward periods expire. For instance—
  - — A "sale" of equipment for tax purposes and a leaseback under a capital lease accounted for as a financing arrangement would accelerate taxable amounts for a difference between the tax basis and the reported amount of the equipment.
  - — A transfer (a "sale" for tax purposes) of installment sale receivables with recourse, accounted for as a financing arrangement for financial reporting, would accelerate taxable amounts for the gains in the installment sales.

Tax-planning strategies that would accelerate deductible amounts to an earlier future year include the following:

- A larger-than-usual annual payment to reduce a long-term pension obligation recognized as a liability in the financial statements

- Disposal of obsolete inventory that is reported at net realizable value in the financial statements

2.10.1 Selected Guidance on Tax-Planning Strategies

Tax-planning strategies do not apply to future events that are not inherently assumed in the financial statements, including those that result in generating profits or incurring losses in future years. Future events that are inherently assumed in the financial statements are those that result in the recovery or settlement of an enterprise's assets or liabilities.

The criteria for using a tax-planning strategy is not that management *expects* to use it, but rather its intent to use it, if necessary, to reduce taxes.

Tax strategies must not give rise to significant costs, expenses, or losses. This limitation includes costs that give rise to assets, for example, future purchases of inventory.

Tax-planning strategies include such elections as—

- Election to file a consolidated return.
- Election to claim either a deduction or a tax credit for foreign taxes paid.
- Election to forego a tax carryback.
- Election to use the subsidiary's (80-percent-or-more-owned) tax basis of net assets rather than the parent's tax basis for the stock of the subsidiary to determine taxable gain or loss on sale or liquidation.

Another tax-planning strategy is to forego a carryback to preclude reopening prior tax years that are otherwise closed.

The consideration of tax-planning strategies, however, is not elective; all strategies must be considered and recognized in each year.

A change in tax status is not a tax strategy but instead is recognized as a discrete event.

The following simple case, which involves the assumed early settlement of a litigation obligation in tax-planning, reduces the overall tax liability as well as the amount classified as a current liability.

Case 6. Tax-planning strategies

FG Corporation

FG Corporation's only temporary differences at December 31, 19X6, consist of the following:

- $60,000 excess of tax depreciation over financial statement depreciation. Reversing 19X7 through 19X9 at $30,000, $20,000, $10,000
- $20,000 reserve for litigation expected to be deductible in 19X9

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

As a tax-planning strategy, management adopts an assumed settlement of its litigation in 19X7. (Management has discretion and control over the timing of the payment.)

An analysis of taxable and deductible amounts as well as the computation of the liabilities for deferred taxes, both with and without the tax-planning strategy, appear in Exhibit 1-6. Under tax planning, the company moved the deductible amount of $20,000 from year 19X9 to 19X7. As a consequence, it was also able to reduce its overall deferred tax accrual by $600:

$$\$10{,}000 \times (40\% - 34\%) = \$600$$

Additionally, it reduced the current balance by $8,000.

If phased-in tax rates have been enacted and a tax-planning strategy is used, scheduling is essential. Scheduling is also essential for current/noncurrent classification of liabilities and assets for deferred taxes.

Exhibit 1-6 *FG Corporation*

	Balance 12/31/X6	*Taxable 19X7*	*(Deductible) 19X8*	*Reversals 19X9*
Depreciation	$ 60,000	$ 30,000	$20,000	$10,000
Litigation reserve	(20,000)	(20,000)		
	$ 40,000	$ 10,000	$20,000	$10,000

Using Tax Planning		
Deferred tax liability current	($10,000 × 40%)	$ 4,000
Deferred tax liability noncurrent	($30,000 × 34%)	$10,200
No Tax Planning		
Deferred tax current	(30,000 × 40%)	$12,000
Deferred tax liability noncurrent	(net of asset)	$ 2,800

2.11 Aggregate Calculation of a Deferred Tax Liability or Asset

Scheduling temporary differences is essential for calculating the deferred tax consequences of these differences because of the following considerations:

- Requirements for offsetting and for recognizing an asset for the deferred tax benefit of net deductible amounts in future years
- Recognition of tax benefits for loss and tax credit carryforwards
- Situations involving scheduled changes in tax rates or the existence of graduated tax rates
- Classification of deferred tax assets and liabilities as current and noncurrent

For the first three items above, overall estimates covering several years of calculations, on an exception basis, are permitted if an enterprise can—

- Identify any significantly large net deductible amounts that do not qualify for recognition of a tax benefit.
- Determine whether or not net taxable amounts are at least sufficient to utilize an operating loss or tax credit carryforward before their expiration.
- Estimate the net taxable or deductible amounts arising in years of phased-in changes in tax laws or rates.

2.12 Graduated Tax Rates

If tax rates are graduated, as in the Internal Revenue Code, then those graduated rates are used to measure the amount of income taxes payable in each future year. It is important to recall that deferred taxes are measured as though the net taxable or deductible amounts arising from the reversal of temporary differences will be the only net taxable or deductible amounts in future years; future earnings and losses do not enter into the computations. Thus, each year's net amounts would first be taxable at the lowest rate, and so on.

SFAS 96 provides three approaches to graduated tax rates:

1. The highest tax rate may be used if the deferred tax liability is large enough to ensure that there will be no significant difference if it is computed by applying the highest tax rate to the aggregate net taxable amount that will arise in future years.
2. An estimated average tax rate may be used if the net amounts that

will become taxable in individual future years seldom or never exceed the level of income subject to the maximum tax rate, and if no unusually large amounts will become taxable in a single future year.

3. If the effect of the graduated rates on the deferred tax is material or there are unusual reversals, then a year-by-year computation would be called for.

In the following case, an enterprise computes deferred taxes on a year-by-year basis.

Case 7. *Year-by-year graduated rates*

GH Corporation

Assume that temporary differences that arise in Year 1 will result in taxable amounts and tax deductions in Years 2 to 4.

	Year 2	*Year 3*	*Year 4*
Taxable amounts	$80,000	$120,000	$70,000
Deductible amount		(30,000)	
	$80,000	$ 90,000	$70,000

Tax rates all years:	15 percent on first	$50,000
	25 percent on next	$25,000
	34 percent on over	$75,000

As indicated in Exhibit 1-7, the deferred tax liability in Year 1 is $46,800. It is important to note that the benefits of the graduated tax rates for all years shown will be recognized in Year 1, thereby reducing the effective tax rate for that year compared to effective rates in the following years (assuming there are no further originating differences).

Exhibit 1-7 *GH Corporation*
Computation of Deferred Taxes for Year 1

			Year		
		Balance	2	3	4
15% first	$50,000	$22,500	$ 7,500	$ 7,500	$ 7,500
25% next	$25,000	17,500	6,250	6,250	5,000
34% over	$75,000	6,800	1,700	5,100	
		$46,800	$15,450	$18,850	$12,500

Deferred tax liability in Year 1 is $46,800.
Deferred tax liability in Year 2 is $31,350.

Thus, in Year 2 the provision for deferred tax is $(15,450).

2.13 Changes in Tax Rates or Tax Status of an Entity

The effects of changes in tax rates or the tax status on an entity's existing deferred tax liabilities or assets are recognized either when the law is enacted or when the entity's status changes. Upon a change in tax status from nontaxable to taxable or the reverse, a deferred tax liability or asset must be recognized or eliminated. The effects are entirely allocated to income from continuing operations.

Note that under APB 11, changes in tax rates or tax laws that affected components of equity, such as translation adjustments, were allocated to that component.

To see the effect of this change in the treatment of the relationship between a deferred tax liability and an equity account, consider the example in Exhibit A.

Exhibit A

An enterprise's only temporary difference at the end of Years 1 and 2 is the foreign currency translation adjustment of $1,000, which arose in Year 0.

The tax rate changes from 40 percent to 34 percent at the beginning of Year 2.

	Year 1	*Year 2*
Income Statement (Selected Accounts):		
Pretax income from continuing operations	$2,000	$2,000
Income tax expense (benefit):		
Current	800	680
Deferred	—	(60)
	$1,200	$ 1,380
Effective tax rate	40%	31%*
Balance Sheet (Selected Accounts):		
Deferred income taxes payable	$ 400	$ 340
Equity:		
Cumulative translation adjustment	$1,000	$1,000
Deferred taxes thereon	400	400
Net balance	$ 600	$ 600

*The effective tax rate is lower than the statutory rate of 34 percent because of the effect of the tax rate change on the temporary difference.

After the tax rate change, the balance in the cumulative translation adjustment account does not reflect the current tax rate.

Exhibit A (cont.)

Under present practice, deferred tax accounts are not adjusted for the effects of tax rate changes until the timing difference reverses. When adjusted, the effects are allocated either to income or to components of equity, such as translation adjustments, if relevant.

Case 8. Change in tax rates

HI Corporation

At December 31, 1985, HI Corporation had charged $10,000 more depreciation for tax than book. This depreciation difference will reverse as follows: 1986—$2,000; 1987—$3,000; and 1988—$5,000.

At December 31, 1985, Company E has recorded a $4,600 deferred tax credit related to this depreciation difference, using the net-change method. Tax rates are: 1985/6—46 percent; 1987—40 percent; and 1988—34 percent.

The computation of the amortization of the deferred tax liability under the liability approach in SFAS 96 and under the deferred approach in APB 11 appears in Exhibit 1-8.

Exhibit 1-8 *HI Corporation*
Amortization of Deferred Tax Credits

Year	Liability Method	Deferred Method
1986—46%	$1,700	$ 920
1987—40%	1,200	1,200
1988—34%	1,700	2,480
Total	$4,600	$4,600

The tax rate change effect is as follows:

	Reversal		
1987	$3,000 × (46 percent − 40 percent)	=	$ 180
1988	5,000 × (46 percent − 34 percent)	=	600
Rate reduction benefit reduces liability in 1986			$ 780
1986 reversal: $2,000 × 46 percent		=	$ 920
Total reduction of liability in 1986			$1,700

Clearly, scheduling is important in this situation. Under APB 11, the effect of the rate reduction would appear in 1988.

2.13.1 Selected Guidance on Changes in Tax Status

Change in status filed. An enterprise that files an election to change its tax status should recognize the effect of that voluntary change either on the date at which the taxing authority approves the change or, if approval is not necessary, on the date of filing the election. The effect of a change in tax status is a discrete event and should be recognized in the period in which it occurs.

Election of S Corporation. If an enterprise elects to convert to S Corporation status after December 31, 1986, it is subject to a corporate level tax on any unrecognized "built-in gain" realized during the ten-year period after the conversion. This gain is taxable on the subsequent disposition of any asset and is determined by applying the maximum corporate rate applicable to the particular type of income (ordinary or capital gain) to the lesser of (a) the amount of the built-in gain realized that year or (b) the amount that would be taxable income that year, if the enterprise were not an S Corporation.

Built-in gains may result in temporary differences which, at the date of conversion, are the excess, if any, of (a) the lower of either the appraised value or the reported amounts of the company's assets over (b) the tax bases of those assets. Note that a temporary difference for inventory is considered to result in a taxable amount in the following year. However, there would be no taxable amount for depreciable assets if those assets were used for future operations.

3. OPERATING LOSS AND TAX CREDIT CARRYBACKS AND CARRYFORWARDS

Prior years' taxes that are refundable by carryback of an operating loss or unused tax credits of the current year are recognized as assets.

An operating loss or tax credit carryforward is recognized as a reduction of a deferred tax liability for temporary differences that will result in taxable amounts during the operating loss or tax credit carryforward period. If not so recognized, the benefit cannot be recognized, regardless of the probability of profits in future years.

Case 9 illustrates the treatment of a net operating loss carryback and carryforward under SFAS 96.

Case 9. Net operating loss (NOL)

IJ Company

Assume that IJ Company has an operating loss of $16,000 in Year 5. Temporary differences in Years 1 to 7 relate to depreciation and are deductible amounts. The temporary differences will result in taxable amounts before the end of the carryforward period from Year 5.

	Year 1	*Years 2 to 4*	*Year 5*	*Year 6*	*Year 7*
Pretax financial income	$ 4,000	$10,000	$(16,000)	$4,000	$14,000
Depreciation differences	(1,600)	(4,400)	(1,200)	(1,600)	(1,200)

Tax rate for Years 1 through 7: 40 percent

The computations of taxable income and tax payable, temporary differences and deferred tax liability balances, and tax expense appear in Exhibit 1-9.

In Year 1, a deferred tax liability of $640 is recognized. In Years 2 to 4, the deferred tax liability increases to $2,400, an increase of $1,760. The temporary taxable differences at the end of Year 4 total $6,000. In Year 5, a $17,200 NOL is incurred, of which $5,600 is carried back to reduce taxable income in Years 2 to 4 and $2,240 of taxes paid is refunded. The $11,600 loss carryforward exceeds the $7,200 of temporary differences that will result in taxable amounts in future years. Therefore, the $2,400 deferred tax liability at the beginning of Year 5 is eliminated. Tax expense in Year 5 is $(4,640).

In Year 6, a portion of the loss carryforward is used to offset taxable income earned in Year 6. The balance of the loss carryforward, $9,200, exceeds the temporary difference of $8,800, and there is no deferred tax liability.

In Year 7, the loss carryforward is used up, and $1,440 of taxes are payable on net taxable income of $3,600. No loss carryforward offsets the $10,000 of temporary differences that will result in taxable amounts in future years, and the $4,000 of deferred tax liability is recognized.

Exhibit 1-9

IJ Company
Taxable Income and Tax Payable

	Year 1	Years 2 to 4	Year 5	Year 6	Year 7
Pretax financial income	$4,000	$10,000	$(16,000)	$ 4,000	$14,000
Depreciation difference	(1,600)	(4,400)	(1,200)	(1,600)	(1,200)
	2,400	5,600	(17,200)	2,400	12,800
Loss carryback	—	—	5,600		
Loss carryforward	—	—	—	(11,600)	(9,200)
Taxable income	$ 2,400	$ 5,600	$(11,600)	$ (9,200)	$ 3,600
Tax payable (refundable)	$ 960	$ 2,240	$ (2,240)	$ —	$ 1,440

Temporary Differences and Deferred Tax Liability Balance

	Year 1	Years 2 to 4	Year 5	Year 6	Year 7
Unreversed Differences					
Opening balance	—	$1,600	$ 6,000	$7,200	$ 8,800
Additions	$1,600	4,400	1,200	1,600	1,200
	1,600	6,000	7,200	8,800	10,000
Tax loss carry-forward	—	—	(11,600)	(9,200)	—
Net taxable amount	$1,600	$6,000	$ —	$ —	$10,000
Deferred Tax Liability					
End-of-year balance	640	2,400	—	—	4,000
Opening balance	—	640	2,400	—	—
Tax expense (benefit)	$ 640	$1,760	$(2,400)	$ —	$ 4,000

Exhibit 1-9 (cont.) *Tax Expense*

	Year 1	*Years 2 to 4*	*Year 5*	*Year 6*	*Year 7*
Tax Expense	$ 960	$2,240	($2,240)	—	$1,440
Deferred	640	1,760	(2,400)	—	4,000
Total	$1,600	$4,000	$(4,640)	—	$5,440

Notes:

- *In Year 5:* $5,600 is carried back to reduce taxable income in Years 2 to 4, and $2,240 of tax is refunded.
- *In Year 6:* A portion of the loss carryforward is used to offset taxable income earned in Year 6.
- *In Year 7:* The loss carryforward is used up.

3.1 Carryforwards for Tax Purposes and for Financial Reporting

If there is an operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is determined by taking the amount for tax purposes: (1) reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward period and (2) increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

If there is no operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

The following examples illustrate the interaction of carryforwards for tax and financial reporting.

Situation 1. An operating loss carryforward for financial reporting when a tax loss carryforward is reduced by temporary differences that will result in taxable amounts during the carryforward period

Year 1 is the first year of operations. The enterprise's only temporary differences are depreciation differences:

	Years 1 to 3	Year 4
Pretax financial income (loss)	$ 800	$(1,200)
Depreciation differences	(160)	(40)
Taxable income (loss)	640	(1,240)
Loss carryback for tax purposes	(640)	640
Loss carryforward for tax purposes	$ —	$ (600)
Loss carryforward for tax purposes		$ (600)
Loss applied to offset depreciation differences ($160 + $40)		200
Loss carryforward for financial reporting		$ (400)

Situation 2. An operating loss carryforward for financial reporting when a tax carryforward is increased by temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements

Year 1 is the first year of operations. The enterprise's only temporary differences are warranty expense differences that will result in deductible amounts in future years.

	Years 1 to 3	Year 4
Pretax financial income (loss)	$ 800	$(1,600)
Warranty expense differences	160	40
Taxable income (loss)	960	(1,560)
Loss carryback for tax purposes	(960)	960
Loss carryforward for tax purposes	$ —	$ (600)
Loss carryforward for tax purposes		$ (600)
Warranty expense differences ($160 + $40)		(200)
Loss carryforward for financial reporting		$ (800)

Situation 3. An operating loss carryforward for financial reporting when there is no operating loss carryforward for tax purposes

Year 1 is the first year of operations. At the end of Year 3, a $2,000 liability for estimated expenses has been recognized in the financial statements, and those expenses will be deductible for tax purposes in Year 4 when the liability is expected to be paid. That temporary difference is the enterprise's only temporary difference.

	Years 1 to 3	Year 3
Pretax financial income (loss)	$800	$(1,600)
Estimated expenses	—	2,000
Taxable income	$800	$ 400
Total temporary differences		$(2,000)
Temporary differences for which a tax benefit is recognized based on recoverability by loss carryback		1,200
Loss carryforward for financial reporting		$ (800)

The tax benefit of an operating loss carryforward that is recognized subsequent to the year of the loss is reported in the same manner as the source of income that gave rise to the utilization of the operating loss carryforward. Under APB 11, the amount was treated as an extraordinary item. In the event of an intervening quasi-reorganization, SFAS 96 requires that—

- Tax benefits of an operating loss or tax credit carryforward for financial reporting, which arose prior to quasi-reorganization that involves both writedowns of assets and the elimination of a deficit, are reported as a direct addition to contributed capital, if the tax benefits are recognized in subsequent years.
- If the quasi-reorganization involves only the elimination of a deficit in retained earnings by reducing contributed capital, then subsequent recognition of a loss carryforward is reported in the same manner as the source of income that gave rise to the utilization of the operating loss carryforward, which then is reclassified from retained earnings to contributed capital.

4. BUSINESS COMBINATIONS

4.1 Purchase Business Combinations

Differences between the assigned values and the tax bases of assets and liabilities (except goodwill or unallocated "negative goodwill" and leveraged leases) of an enterprise acquired in a purchase business combination require the recognition of a deferred tax liability or asset.

SFAS 96 changes current practice, which utilizes a net-of-tax approach and a discounted valuation. Both of these applications would be proscribed under the new Statement.

Situation 1 illustrates the application of SFAS 96 to a nontaxable purchase combination.

Situation 1. Purchase business combination—nontaxable, differences between assigned values and tax basis of assets.

Purchase price	$40,000
Tax basis of net assets acquired	10,000
Assigned value of net assets other than goodwill	24,000

Tax rate is 40 percent

Future recovery of assets and settlements of liabilities will result in taxable and deductible amounts that can be offset against each other

The application of SFAS 96 requires that goodwill of $21,600 and a deferred tax liability of $5,600 be recognized as follows:

Net assets	$24,000	
Goodwill	21,600	
Deferred tax liability		$ 5,600
Cash		40,000

The deferred tax liability is: ($24,000 − $10,000) × .4 = $ 5,600

The difference between assigned net asset value and the tax basis is a temporary difference.

Situation 2 illustrates a taxable purchase combination if assigned values for book and tax differ.

Situation 2. Business combination—taxable, different values assigned to goodwill for tax and accounting purposes.

Purchase price	$40,000
Tax basis of net assets acquired other than goodwill	40,000
Accounting basis of net assets acquired other than goodwill	24,000

Tax rate: 40 percent.

The acquiring enterprise has a deferred tax liability of $60,000 that will result in net taxable amounts in future years, and the acquired $16,000 of temporary differences will result in deductible amounts in those same future years.

SFAS 96 allows the use of future taxable amounts of the acquiring company to determine the amount of future deductible amounts of the acquired company, which can be recognized at the date of acquisition. Therefore, the debit to deferred tax liability is an offset to the deferred tax credit of the acquiring company.

The amount is based on 40 percent of the temporary difference ($40,000 − $24,000).

Net assets other than goodwill	$24,000	
Deferred tax liability (acquiring enterprise)	6,400	
Goodwill	9,600	
Cash		$40,000

If the tax and accounting bases of net assets are identical, there are no temporary differences.

4.2 Operating Loss and Tax Credit Carryforward—Purchase Method

Accounting for a business combination should reflect any provisions in tax laws that permit or restrict the use of either company's operating loss carryforwards to reduce taxable income or taxes payable that are attributable to the other company after the combination.

If permitted by tax law or by tax election (consolidated tax return), an operating loss or tax credit carryforward for financial reporting purposes of either combining enterprise may be recognized, as of the acquisition date, as a reduction of the other's deferred tax liability. The result would be either to reduce goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise, or to create or increase negative goodwill.

Note: The Tax Reform Act of 1986 changed rules regarding the utilization of carryforwards of other companies. Therefore, recognition of an acquired company's NOL as an offset to an acquirer's deferred tax liability may be an exception rather than the rule.

In contrast to the new rules, under APB 11—

- Net-of-tax values were required to be assigned to acquired assets and liabilities.
- Subsequent recognition of purchased NOL carryforwards could result in retroactive restatement of purchase price allocation.
- Carryforwards subsequently recognized were recorded by reducing goodwill to zero; then noncurrent assets were reduced, and any remaining amounts were recorded as a negative goodwill.
- No consideration could be given to an acquirer's NOL or tax credit carryforwards at the acquisition date.

To illustrate the application of SFAS 96 to a purchase combination in which a loss carryover exists, consider the following facts:

Loss carryforward—nontaxable purchase business combination

Purchase price	$40,000
Net assets—assigned value	24,000
—tax basis	10,000
Acquired enterprise—operating loss carryforward (may be used by acquiring company in the consolidated tax return)	32,000

Tax rate: 40 percent.

Temporary differences of the acquiring and acquired companies will result in taxable amounts before the end of the loss carryforward period.

The acquiring company has a liability for temporary differences that will result in $60,000 of net taxable amounts in future years.

In this situation, the $32,000 operating loss carryforward offsets the $14,000 net taxable amount. This is the difference between the tax basis and accounting basis of net assets, and it will result in future taxable amounts. The remaining $18,000 operating loss carryforward will be offset against the acquiring company's deferred tax liability. This step results in reducing the acquiring company's deferred tax liability in the amount of $7,200:

$$\$18{,}000 \times 40 \text{ percent} = \$7{,}200$$

It reduces an amount that would otherwise be assigned to goodwill:

Journal entry		
Net assets	$24,000	
Deferred tax liability	7,200	
Goodwill	8,800	
Cash		$40,000

4.3 Carryforward—Pooling-of-Interests

For restatement of periods prior to the combination, an operating loss carryforward of an acquired enterprise does not offset the acquiring company's taxable income because consolidated tax returns cannot be filed for those periods.

If consolidated tax returns are expected to be filed subsequent to the combination, however, then one combining company's operating loss carryforward in a prior period reduces the other enterprise's deferred tax liability in the loss and subsequent periods to the extent that (a) the temporary differences will result in taxable amounts subsequent to the combination date and (b) the loss carryforward can reduce those taxable amounts based on tax law provisions.

The tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods.

The same requirements apply to tax credit carryforwards and to temporary differences that will result in net deductible amounts in future years.

A pooling-of-interests combination may be a taxable combination. The increase in the tax basis of the net assets acquired results in temporary differences that require a deferred tax liability or asset. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis, which became recognizable after the combination date, are reported as a reduction of income tax expense.

4.4 Subsequent Recognition of Carryforward Benefits

If not recognized at the acquisition date, the tax benefits of an acquired enterprise's operating loss or tax credit carryforward for financial reporting purposes, which are recognized in financial statements after the acquisition date, should first be used to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition, and next be recognized as a reduction of income tax expense.

Additional amounts of carryforwards for financial reporting purposes that arise after the acquisition date, and before recognition of the tax benefits of amounts existing at the acquisition date, are recognized as a reduction of income tax expense.

If both types of carryforwards exist, the attribution of the tax benefit is determined by the tax law provisions that identify the sequence in which the amounts are utilized for tax purposes. If not determinable by tax law provisions, the tax benefit recognized is prorated between a reduction of goodwill and other noncurrent intangibles, and income tax expense.

The following case illustrates the recognition of tax benefits subsequent to a business combination:

Case 10. Recognition of tax benefits subsequent to a business combination

JK Corporation

JK Corporation acquires S Company in a nontaxable purchase business combination occurring January 1, 1988.

	Assigned Values	*Tax Basis*
Net assets acquired	$10,000	$12,000
Goodwill (no other intangibles)	3,000	
Purchase price	$13,000	

Facts:

- The excess of tax basis over the assigned value of identified net assets does not meet the criteria for recognition of a deferred tax asset. There are no other temporary differences.
- Disregard goodwill amortization.
- Pretax loss from operations 1988 is $6,000. Pretax income from operations 1989 is $5,000.
- In 1988, the $10,000 in net assets acquired are sold at book value, giving rise to a $2,000 tax loss.
- Tax rate in 1988 and 1989 is 40 percent.

The determination of taxable income and net income for 1988 and 1989, as well as the the application of SFAS 96 to determine income tax expense, appears in Exhibit 1-10. The realization in 1989 of the tax benefit of the tax loss carryforward of $2,000 ($5,000 × 40 percent) is apportioned between the tax loss on the sale of assets and the operating loss.

The $8,000 loss carryforward at the end of 1988 has two components. One component (25 percent) is $2,000 attributable to the excess of tax basis over the assigned value of the identified net assets acquired at the date of the business combination. The other component (75 percent) is $6,000 attributable to losses occurring after the business combination. Provisions in the tax law do not distinguish between these two components, and the component that is utilized for tax purposes is indeterminable. In 1989, therefore, the $2,000 tax benefit ($5,000 at 40 percent) is prorated so that goodwill is reduced $500 (25 percent of $2,000) and tax expense is reduced $1,500 (75 percent of $2,000). Because $500 of the tax benefit reduces goodwill, $500 of tax expense is reported in 1989.

Financial and taxable income for 1990 is as follows:

JK Corporation

	Financial Income	*Taxable Income*
Income from operations	$3,000	$3,000
Loss carryforward		(3,000)
Taxable income		$ —

The consolidated statement of earnings would be as follows:

Pretax income	$3,000
Income tax expense	300
Net income	$2,700

The $1,200 benefit of the operating loss carryforward ($3,000 at 40 percent) is prorated so that goodwill is reduced $300 (25 percent of $1,200) and tax expense is reduced by $900 (75 percent of $1200). Because $300 of the tax benefit reduces goodwill, $300 of tax expense is reported in 1990.

Exhibit 1-10 *Allocation of Tax Benefit of Tax Loss Carryforward After a Purchase Combination*

	JK Corporation	
	Financial Income	*Taxable Income*
Tax Determination		
1988—Pretax operating loss	$(6,000)	$(6,000)
Loss on sale of assets		(2,000)
Tax loss carryforward (no taxes paid in prior years)		$(8,000)
1989—Pretax income from operations	$ 5,000	$ 5,000
Tax loss carryforward		(8,000)
Taxable income		$ —

	1988	1989
Income Statement		
Pretax income (loss)	$(6,000)	$5,000
Income tax expense	—	500
Net income (loss)	$(6,000)	$4,500

Apportionment of Tax Benefit of Loss

Tax loss on asset sales	$2,000	= 25% × $2,000 = $500 allocated to goodwill reduction
Operating loss	$6,000	= 75% × $2,000 = $1,500 allocated to tax expense reduction
	$8,000	

Journal Entry:

Income tax expense	$500	
Goodwill		$500

4.4.1 Selected Guidance on Business Combinations

Acquired NOL. The recognition of an acquired NOL or tax credit carryforward should first be applied to reduce goodwill to zero. Next, other noncurrent intangible assets related to the acquisition are reduced to zero. Then, any additional recognized benefit reduces income tax expense.

Subsequent recognition of acquiring company's NOL. If a tax benefit for some or all of an acquiring company's operating loss carryforward for financial reporting cannot be recognized at the acquisition date as a reduction of the acquired company's deferred tax liability because the tax criteria are not met, the tax benefit should be reported as a reduction of income tax expense when recognized in the financial statements for subsequent years.

Other intangibles. Deferred taxes should be provided for temporary differences related to intangible assets other than goodwill. Goodwill, a residual, is one of the four exceptions to comprehensive tax allocation.

Potential reallocation for tax purposes. If a reallocation of the purchase price for tax purposes is probable, recognition and measurement of a deferred tax liability or asset at the date of the purchase business combination should be based on the expected final tax allocation, not the initial allocation. For reporting periods prior to finalization of the purchase price allocation, the enterprise should (a) recognize a deferred tax liability for those excess tax deductions and (b) determine deferred taxes based on the expected final purchase price allocation. At the date the purchase price allocation is finalized, the enterprise should adjust its deferred tax liability or asset to reflect the revised tax basis of the purchased assets and liabilities as well as the amount of any IRS settlement for prior years' income taxes. The effect of that adjustment should be applied to increase or decrease the remaining balance of goodwill.

5. INTRAPERIOD ALLOCATION OF INCOME TAXES

Income taxes should be allocated to continuing operations, discontinued operations, extraordinary items, the cumulative effect of accounting changes, prior period adjustments, and gains or losses included in comprehensive income but excluded from net income and capital transactions.

5.1 Allocation Within the Income Statement

The amount of income tax expense or benefit allocated to income or loss from continuing operations (in addition to adjustments for changes in tax status and tax laws or rates) is computed on the pretax income or loss, exclusive of any other items that occurred during the year (for example, extraordinary items).

The amount of tax allocated to items other than continuing operations is based on the incremental effect on income taxes that results from that category of items.

When allocated to two or more categories of items other than continuing operations, the sum of the incremental tax effects of each category of items may not equal the incremental tax effect of all categories of items because of a statutory limitation on the utilization of tax credits, for example. In those circumstances, the allocation procedure is as follows:

- Determine the incremental tax benefit of the total net loss for all net loss categories and apportion that incremental benefit ratably to each net loss category.
- Apportion ratably to each net gain category the difference between the incremental tax effect of all categories other than continuing operations and the incremental tax benefit of the total net loss for all net loss categories.

The procedure for allocating income taxes to each item within each category of items is similar to the procedure described above.

Consider a simple situation of intraperiod tax allocation. Assume that pretax financial income and taxable income are the same.

Loss from continuing operations	$(1,000)
Loss carryback would give rise to a refund of $200 of taxes paid on $500 of taxable income during the carryback years	
Extraordinary gain	1,800

The tax rate is 40 percent.

Income taxes currently payable are $320 on $800 of taxable income.

The allocation of income tax expense between loss from continuing operations and extraordinary gain is computed as follows:

Loss from continuing operations	$(1,000)
Extraordinary gain	1,800
Taxable income	$ 800
Tax expense	$ 320

Tax rate: 40 percent

Allocation:	
Tax consequences of loss from continuing operations	$ (200)
Extraordinary gain—incremental tax consequences	520

This hypothetical computation of tax consequences of loss from continuing operations results in an incremental tax of $520 on extraordinary gain. Tax on an extraordinary gain on a stand-alone basis would be $720.

Case 11 illustrates intraperiod tax allocation when there is more than one category other than continuing operations.

Case 11. Intraperiod tax allocation within the income statement—more than one category other than continuing operations

KL Corporation

Pretax financial income includes:	
Income from continuing operations	$1,200
Discontinued operations	(200)
Extraordinary items	1,000
Cumulative effect of an accounting change	(400)
Total pretax financial income	$1,600

KL Corporation has $600 of tax credits available, subject to a 90-percent-of-taxes-payable limitation.

There are no temporary differences.

Tax rate is 34 percent.

The solution to Case 11 appears in Exhibit 1-11.

Exhibit 1-11 *KL Corporation*
Income Tax Expense Attributable to Continuing Operations

	Continuing Operations	*Total*
Pretax financial income	$1,200	$1,600
Tax at 34 percent	408	544
Tax credits (90-percent limitation)	367	490
Tax expense	$ 41	$ 54

The incremental effect of income tax from all items other than continuing operation is $13.

The allocation of the incremental effect is as follows:

	Sum of Loss Categories	*Loss Category Discontinued Operations*	*Loss Category Cumulative Effect of Change*
Taxable income	$1,600	$1,600	$1,600
Loss category	(600)	(200)	(400)
Taxable income without loss categories	$2,200	$1,800	$2,000
Tax at 34 percent	748	612	680
Tax credit (90-percent limit)	600	550	600
Tax without loss category	148	62	80
Total expense	54	54	54
Incremental effect	$ 94	$ 8	$ 26

The $94 tax benefit is allocated on a *pro-rata* basis to the sum of the net loss categories:

	Each Loss Category		*Apportioned*
	Amount	*Percent*	*Amounts*
Discontinued operation	8	24%	22
Cumulative effect	26	76%	72
	$34	100%	$94

The tax allocated to the extraordinary is $107. This is the difference between the $13 tax expense for all other items and the $94 tax benefit for the loss categories.

Total tax expense is allocated as follows:

	Pretax Income	*Tax Expense*
Income from continuing operations	$1,200	$ 41
Discontinued operations	(200)	(22)
Extraordinary items	1,000	107
Change in accounting	(400)	(72)
	$1,600	$ 54

5.1.1 Selected Guidance on Allocation of Income Tax Expense Within the Income Statement

Deferred tax expense or benefit should be allocated to income from continuing operations and other items in the same manner as current tax expense or benefit.

A company allocating a deferred tax benefit to continuing operations should consider the total amount of income taxes paid during the carry-back period, not just the portion of those taxes allocated to continuing operations.

Note that no portion of tax expense for the current year should be allocated to any accounting change that is computed in accordance with paragraph 20 of APB Opinion No. 20, *Accounting Changes*.

5.2 Allocation of Income Tax to Stockholders' Equity

Stockholders' equity is charged or credited for the income tax effects of—

- Adjustments to the opening balance of retained earnings for a change in accounting principles or for correction of an error.
- Gains and losses recognized in comprehensive income but not in net income.
- An increase or decrease in contributed capital (for example, expenditures reported as a reduction in the proceeds from the issuance of capital stock).
- Expenses for employee stock options recognized differently for financial reporting and tax purposes.

Note: An income tax benefit for the tax deductibility of dividends paid to stockholders is recognized as a reduction of income tax expense; it is not credited directly to stockholders' equity.

6. DISCLOSURE REQUIREMENTS

6.1 Balance Sheet

A deferred tax liability or asset should be classified in two categories—current and noncurrent—in a classified balance sheet. The current amount is the net deferred tax consequences of—

- Temporary differences that will result in net taxable or deductible amounts during the next year.
- Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year.
- Temporary differences for which there is no related identifiable asset or liability for financial reporting whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year.

Deferred items attributable to different tax jurisdictions should not be offset.

The nature or type of temporary differences that give rise to a significant portion of a deferred tax liability or asset should be disclosed.

A public enterprise not subject to income tax because its income is taxed directly to its owners should disclose that fact as well as the net difference between the tax basis and the reported amounts of the enterprise's assets and liabilities.

Detailed disclosures are called for whenever a deferred tax liability is not recognized for any of the areas addressed in APB 23 or for deposits in statutory reserve funds by U.S. steamship enterprises (see SFAS 96, paragraph 25).

In the following three situations, the tax rate is 40 percent, and the temporary differences are scheduled. The requirement is to determine the current/noncurrent amounts for deferred tax. (Assume that the enterprise has no taxable income in Year 1, the start of operations.)

	Temporary Differences	*Future Years*		
		Year 2	*Year 3*	*Year 4*
Situation 1:				
Liability for warranties	$(1,000)	$(1,000)	—	
Installment receivables	1,600	—	$ 1,600	
	$ 600	$(1,000)	$ 1,600	
Situation 2:				
Liability for warranties	$(1,000)	—	$(1,000)	
Installment receivables	1,600	1,600	—	
	600	1,600	$(1,000)	

	Temporary Differences	Future Years Year 2	Year 3	Year 4
Situation 3:				
Liability for warranties	$(1,000)	$(1,000)	—	
Installment receivables	1,600	—	$ 1,600	
Liquor inventory*	1,400	—	—	$1,400
	$ 2,000	$(1,000)	$ 1,600	$1,400

*Operating cycle—3 years

In situation (1), the deductible amount in Year 2 is carried forward to Year 3. Therefore , the deferred tax liability of $240 (40 percent x $600) is noncurrent.

Situation (2) presents a noncurrent deferred tax asset of $400 (40 percent × $1,000) and a current deferred tax liability of $640 (40% × $1,600). The deductible amount of $1,000 can be carried back to Year 2 to offset the taxable amount of $1,600 and, therefore, can be recognized as an asset.

Finally, in situation (3), there would be a current liability for the inventory because the recovery falls within the operating cycle ($1,400 × 40% = $560). The warranty difference of $1,000 would be carried forward to Year 3 and offset against the taxable amount of $1,600, reducing the taxable balance to $600. The noncurrent deferred tax liability would be $240 ($600 × 40%).

6.2 Income Statement

Disclosure is required of the amount of income tax expense allocated to:

- Continuing operations
- Discontinued operations
- Extraordinary items
- Cumulative effect of accounting changes
- Prior period adjustments
- Gains and losses included in comprehensive income but excluded from net income
- Capital transactions

Note that SFAS 96 precludes including interest and penalties in tax expense.

The significant components of income tax attributed to continuing operations for each year presented should be disclosed, including the following:

- Current tax expense or benefit (exclusive of interest and penalties, which are not to be reported as taxes)
- Deferred tax expense or benefit
- Investment tax credit
- Government grants
- Operating loss carryforward benefits
- Adjustments of deferred tax for changes in tax laws, rates, or the tax status of an entity

Use percentages or dollar amounts to reconcile the reported amount of tax expense attributable to continuing operations to the amount that would have been reported by applying the domestic federal statutory rates to pretax income from continuing operations. If there is an alternative tax system, regulatory rates should be used as the statutory rates.

The estimated amount and nature of each reconciling item should be disclosed. Nonpublic enterprises may omit reconciling items but must disclose the nature of significant items.

Disclose the amounts and expiration dates of operating loss and tax credit carryforwards for (a) financial reporting purposes (amounts not recognized as reductions of a deferred tax liability) and (b) tax purposes.

If any amount of benefit is used to reduce goodwill, it should be disclosed separately.

If a company is included in a consolidated tax return, then it should disclose in its separate statements—

- The amount of current and deferred tax expense.
- The amount of tax-related balances due to, or from, affiliates.
- The method of intercompany tax allocation as well as the nature and effects of any method changes.

6.2.1 Selected Guidance on Disclosure Requirements

Current/noncurrent classification. Inventory is the only balance-sheet item that is classified as current because of an operating cycle that is longer than one year. All other items are classified in relation to a one-year operating cycle.

Disclosure of significant components of income tax expense. SFAS 96 requires the disclosure of the significant components of income tax expense attributable to continuing operations. The sum of the amounts disclosed should equal the amount of tax expense that is reported in the income statement. Separate disclosure of the tax benefit of operating loss carryforwards and tax credits that have been recognized as a reduction of current and deferred tax expenses is required. But the amounts disclosed for current and deferred tax expenses can either be before or after the reduction for those tax benefits.

If a tax benefit for an operating loss carryforward is recognized by reducing a deferred tax liability in Year 1, and the carryforward is realized on the tax return in Year 2, there is no effect on income tax expense in Year 2; the reduction in current tax expense for the benefit realized in Year 2 is offset by the increase in the deferred tax expense.

Acquired operating loss carryforward benefit. If the tax benefit of an acquired operating loss carryforward is recognized after the date of a purchase business combination, and it is applied to reduce goodwill and intangible assets, income tax expense is increased. Disclosure is required for any increase in the current or deferred tax expense that results from applying the tax benefit of an acquired operating loss carryforward to reduce goodwill and intangible assets.

Expiration dates for operating loss carryforwards for financial reporting. Operating loss carryforwards for tax purposes that do not offset temporary differences resulting in taxable amounts have expiration dates as determined by tax law. The expiration dates for temporary differences are determined by adding the loss carryforward period to the particular future years in which those temporary differences will result in net deductible amounts.

7. EFFECTIVE DATES AND TRANSITION

SFAS 96 is effective for fiscal years beginning on or after December 15, 1988. SFAS 100 recently amended SFAS 96, postponing the effective date to fiscal years beginning after December 15, 1989. Earlier application is encouraged, and restatement of previously issued financial statements is permitted.

7.1 Initial Application

Initial application should be made as of the beginning of an enterprise's year.

If restatement is elected and the earliest year restated is prior to those years presented in the financial statements, then the cumulative adjustment should be made to the opening balance of the retained earnings of the earliest year presented.

In all other cases, the cumulative effect should be included in determining net income of the earliest year restated or, if no prior year is restated, of the year first applied. Pro-forma effects of retroactive application are not required if statements of earnings presented for prior years are not restated.

The financial statements for the year in which SFAS 96 is first adopted should disclose the effect of adopting the Statement on (a) income from continuing operations (b) income before extraordinary items (c) net income and (d) related per share amounts. Also, a similar disclosure should be made for the effect of any restatements.

If restatement is elected, the company must remeasure in accordance with SFAS 96 *all* purchase business combinations that occur in the first year restated and in all subsequent years.

For purchase combinations consummated prior to the beginning of the earliest year restated, or if restatement is not elected, the enterprise may not remeasure any prior purchase business combinations; remaining balances will be left unchanged. Except for leveraged leases, any differences between those remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset should be recognized as of the beginning of the year in which the Statement is first adopted. In most cases, this will increase the cumulative effect.

Note: Special provisions apply to regulated enterprises.

The following situation illustrates the financial statement effects of remeasurement versus nonremeasurement of purchase combinations.

Situation

MN Corporation

Assume that MN Corporation acquires Company S's assets in a 1985 purchase business combination. The assets had an initial fair value of $200 and a tax basis of $0. The tax rate at the date of acquisition was 40 percent, and the net-of-tax value was recorded at $120. The asset has not been amortized to date.

If MN restates its 1985 financials, it must remeasure prior business combinations as follows:

The asset was initially recorded net-of-tax	$120
Deferred tax gross up	80
Revised book value	200
Tax basis	0
Temporary difference	200
Tax rate	40%
Deferred tax liability	$ 80

Note: No cumulative effect adjustment is made because the net asset under the liability method, and the result under the old rule, are identical.

If the company does not restate 1985, it does not remeasure prior business combinations, and the analysis is as follows:

Recorded book value	$120
Tax basis	0
Temporary difference	120
Tax rate	40%
Deferred tax liability	$ 48

A cumulative effect of $48 would be recorded in this case.

In future periods, under the restatement and remeasurement approach, income would be reduced by $120 resulting from the amortization of the $200 asset and the reversal of the $80 deferred tax liability.

Under the no-restatement-and-remeasurement approach, the amortization of the $120 asset would be offset by the reversal of the $48 tax liability, reducing net income by $72.

Note that the transition approach can affect future reported earnings.

7.1.1 Selected Guidance on Transition

If an enterprise elects to apply SFAS 96 by restating prior years, it may choose the earliest year that is restated. The enterprise need not restate all prior years' financial statements presented.

SFAS 96 further notes the following situations where a transition adjustment, or a part thereof, is to be excluded from net income:

- Paragraph 33—Initial recognition of the tax benefits related to a quasi-reorganization
- Paragraph 23—Tax benefit of an acquired operating loss or tax credit carryforward
- Paragraph 75—Tax benefits of deductions related to employee stock options credited to capital
- Paragraph 70—Tax benefits attributable to the increase in tax bases of assets acquired in a taxable business combination accounted for as a pooling

If an enterprise adopts SFAS 96 by the cumulative catch-up method, it may not remeasure business combinations consummated in a prior year. This may mean that a loss will be reported when liabilities recorded on a net-of-tax basis are settled.

8. IMPLEMENTATION

The 1988 edition of *Accounting Trends and Techniques* indicates that 37 companies have adopted SFAS 96. Of that number, 27 did not restate prior years while 10 companies did. The 1988 edition includes companies with fiscal years ending on or before January 31, 1988.

8.1 No Restatement

Companies that choose not to restate prior years show the cumulative effect of the adoption in income in the adoption year. For example, Mapco, Inc.'s 1987 annual report includes a credit of $51,129,000 in income as the cumulative effect of a change in accounting method for income taxes (see Figure 1-1). In its note on accounting policies, Mapco states:

Figure 1-1

MAPCO *Inc.*
Consolidated Statement of Income
Year Ended December 31
(Dollars in Thousands Except Per Share Amounts)

	1987	*1986*	*1985*
Sales[1]	$1,499,966	$1,430,036	$1,768,621
Operating Revenues	136,540	139,873	139,049
	1,636,506	1,569,909	1,907,670
Expenses:			
Outside purchases of crude oil, natural gas liquids and other products	914,391	833,922	1,140,544
Operating	346,838	335,530	353,385
Depreciation, depletion and impairments	88,330	72,209	65,873
Selling, general and administrative	68,299	65,549	60,968
Taxes other than income taxes	99,590	103,399	107,063
Interest and debt expense	36,746	41,605	41,245
Other expense (income)—net	800	(10,742)	(31,393)
Loss on disposal of barging operating (Note 12)	—	—	6,685
	1,555,994	1,441,472	1,744,370
Income Before Provision for Income Taxes	80,512	128,437	163,300
Provision for Income Taxes (Note 8)	23,728	49,409	57,922
Income from Consolidated Operations	56,784	79,028	105,378
Income(Loss) of Unconsolidated Affiliate (Note 6)	478	(746)	(1,313)
Income Before Extraordinary Item and Cumulative Effect of Accounting Change	57,262	78,282	104,065
Extraordinary Loss from Debt Extinguishment (Note 9)	—	(4,133)	—
Cumulative Effect of Change in Method of Accounting for Income Taxes (Note 8)	51,129	—	—
Net Income	$ 108,391	$ 74,149	$ 104,065
Earnings per Common Share:			
Income before extraordinary item and cumulative effect of accounting change	$ 2.75	$ 3.67	$ 3.60
Cumulative effect of change in method of accounting for income taxes	$ 2.45	$ —	$ —
Net income	$ 5.20	$ 3.48	$ 3.60
Average Common Shares Outstanding	20,855,044	21,302,426	28,909,806

(1) Includes consumer excise taxes of $55,570, $62,990 and $62,107 in 1987, 1986 and 1985, respectively.

See notes to consolidated financial statements.

The net change for the year in the deferred income tax liability is recognized as deferred income tax expense. The deferred income tax liability is based on enacted tax laws and the expected reversal of the temporary differences between the financial and tax basis of assets and liabilities. Prior to 1987, deferred income taxes were provided for timing differences between book and taxable income at statutory tax rates in effect in the period when the differences occurred. Investment tax credits are recorded as a reduction of the provision for income taxes in the year the related assets are placed in service.

The credit on adoption stems from the use of enacted statutory rates to compute the deferred tax liability rather than rates that were in effect when the timing differences arose, as under APB 11. Thus, if there is no restatement of earlier years, the reduction in tax rates under the Tax Revenue Act of 1986 impacts income in the adoption year.

In Figure 1-2, the section entitled "Note 8. Income Taxes" includes the disclosures called for under SFAS 96, including the effect of the method change on income; the components of pretax income and income taxes, both current and deferred; a reconciliation of the statutory and effective tax rates; and the elements that make up the provision for deferred income taxes.

Figure 1-2 *MAPCO Inc.*
Note 8. Income Taxes

In 1987, MAPCO adopted Statement of Financial Accounting Standards No. 96, *Accounting for Income Taxes*, and elected to report the effect of applying this Statement as a cumulative effect of a change in accounting principal as of January 1, 1987. The effect in 1987 of adopting this Statement was to increase net income by $51,129,000, or $2.45 per share.

The deferred income tax liability presented in MAPCO's Consolidated Balance Sheet represents income taxes at enacted statutory rates on temporary differences which are primarily comprised of the excess of tax over book depreciation and property, plant and equipment costs expensed for tax and capitalized for book purposes.

The components of income before provision for income taxes are (in thousands):

Year Ended December 31,	*1987*	*1986*	*1985*
Domestic operations	$ 76,949	$126,606	$155,614
Foreign operations	3,563	1,831	7,686
Income before provision for income taxes	$80,512	$128,437	$163,300

Figure 1-2 (cont.)

The components of the provision for income taxes are (in thousands):

Year Ended December 31,	*1987*	*1986*	*1985*
Current:			
Federal	$15,218	$ 11,993	$ 25,996
State	1,270	(317)	3,250
Foreign	1,196	904	3,114
	17,684	12,580	32,360
Deferred:			
Federal	7,459	38,400	33,381
Foreign	(32)	(691)	505
Investment tax credits	(1,383)	(880)	(8,324)
Provision for income taxes	$ 23,728	$ 49,407	$ 57,922

A reconciliation of the statutory Federal income tax rate and MAPCO's effective income tax rate is as follows (in percents):

Year Ended December 31,	*1987*	*1986*	*1985*
Statutory rate	40.0	46.0	46.0
Increase (decrease) resulting from:			
Excess of tax over book depletion	(8.6)	(6.0)	(2.6)
Investment tax credits	(1.7)	(.7)	(5.1)
Tax exempt investment earnings	(1.2)	(1.1)	(4.2)
Other	1.0	.3	1.4
Effective income tax rate	29.5	38.5	35.5

The provision for deferred income taxes consists of the following (in thousands):

Year Ended December 31,	*1987*	*1986*	*1985*
Tax over book depreciation	$ 7,921	$ 17,424	$ 21,349
Income recognition	1,790	8,974	(717)
Coal property development and exploration costs expensed for tax purposes	1,288	1,241	—
Accrued liabilities	(907)	1,502	908
Asset impairments	(805)	6,098	865
Interest capitalized	86	113	1,912
Investment tax credit and ESOP credit recognition	—	(1,038)	8,764
Provision for deferred income taxes	$ 7,427	$ 37,709	$ 33,886

In its 1987 annual report, General Electric Company includes the cumulative effect of adopting SFAS 96 (see Figure 1-3). The reduction in deferred income tax on adoption totaling $577,000,000 stems from the recomputation of the opening balance of deferred taxes, using the tax rates expected to be in effect when taxes are actually paid or recovered. Note 8 in the annual report (see Figure 1-4) discloses the significant components of the normal provision for income taxes by taxing jurisdiction; principal items comprising deferred U.S. federal income taxes; the treatment of the ITC; a reconciliation of the federal statutory rate with the effective rate on income from continuing operations; the amount of undistributed earnings intended to be reinvested indefinitely in affiliates and associates as well as related income tax effects; and other items.

Figure 1-3 *Statement of Earnings*
General Electric Company and Consolidated Affiliates
For the Years Ended December 31 (In Millions)

	1987	*1986*	*1985*
Revenues			
Sales of goods	$29,937	$28,139	$23,963
Sales of services	9,378	7,072	4,323
Earnings of General Electric Financial Services, Inc. (note 15)	552	504	413
Other income (note 5)	648	1,013	541
Total revenues	40,515	36,728	29,240
Costs and expenses			
Cost of goods sold	22,359	20,757	17,672
Cost of services sold	7,298	5,430	3,171
Selling, general and administrative expense	5,979	5,963	4,594
Interest and other financial charges (note 6)	645	625	361
Unusual items (note 7)			
(Gains) from sales of assets	—	(50)	(518)
Provisions for business restructuring activities	1,027	311	447
Special payment to nonexempt and hourly employees	—	—	93
Total costs and expenses	37,308	33,036	25,820
Earnings before income taxes, extraordinary item and cumulative effect of changes in accounting principles	3,207	3,692	3,420
Provision for income taxes (note 8)	(1,088)	(1,200)	(1,143)

Figure 1-3 (cont.)

	1987	1986	1985
Earnings before extraordinary item and cumulative effect of changes in accounting principles	2,119	2,492	2,277
Extraordinary item—GE Capital Corporation loss on early extinguishment of certain long-term debt (note 15)	(62)	—	—
Cumulative effect to January 1, 1987 of initial application of Statement of Financial Accounting Standards No. 96—"Accounting for Income Taxes" (note 1)			
GE and consolidated affiliates	59	—	—
GE Financial Services, Inc.	518	—	—
Cumulative effect to January 1, 1987 of changing overhead recorded in inventory (note 1)	281	—	—
Net earnings	$ 2,915	$ 2,492	$ 2,277
Net earnings per share (in dollars)			
Before extraordinary item and cumulative effect of changes in accounting principles	$ 2.33	$ 2.73	$ 2.50
Extraordinary item—GE Capital Corporation loss on early extinguishment of certain long-term debt	(.07)	—	—
Cumulative effect to January 1, 1987 of initial application of Statement of Financial Accounting Standards No. 96—"Accounting for Income Taxes"			
GE and consolidated affiliates	.06	—	—
GE Financial Services, Inc.	.57	—	—
Cumulative effect to January 1, 1987 of changing overhead recorded in inventory	.31	—	—
Net earnings per share	$ 3.20	$ 2.73	$ 2.50
Dividends declared per share (in dollars)	$ 1.325	$ 1.185	$ 1.115

The notes to financial statements on pages 37-51 are an integral part of this statement. Per-share amounts have been adjusted for the 2-for-1 stock split in April 1987. Financial information includes RCA results from June 1, 1986.

Figure 1-4

General Electric Company
and Consolidated Affiliates
Note to Financial Statements
Provision for Income Taxes (Excluding Extraordinary Item and Cumulative Effect of Changes in Accounting Principles)

Significant components of the normal provision for income taxes by taxing jurisdiction are shown below.

Provision for Income Taxes (In millions)	*1987*	*1986*	*1985*
U.S. federal income taxes:			
Estimated amount payable	$ 956	$1,062	$ 842
Deferred tax expense (benefit)	(65)	(95)	90
Investment credit deferred (amortized)—net	(87)	(38)	35
	804	929	967
Foreign income taxes:			
Estimated amount payable	197	198	135
Deferred tax expense (benefit)	8	(24)	(4)
	205	174	131
Other (principally state and local income taxes)	79	97	45
	$1,088	$1,200	$1,143

Deferred income taxes for 1987 reflect the impact of "temporary differences" between the amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations. These "temporary differences" are determined in accordance with Statement of Financial Accounting Standards No. 96 (see note 1) and are more inclusive in nature than "timing differences" as determined under previously applicable generally accepted accounting principles. Deferred income taxes for 1986 and 1985 have not been restated. Principal items making up the deferred U.S. federal income tax provisions follow.

Deferred U.S. Federal Income Taxes Increase (Decrease) in Provision for Income Taxes (In millions)	*1987*	*1986*	*1985*
Tax over book depreciation	$ 18	$ 87	$124
Margin on installment sales	(16)	(33)	48
Provision for warranties	9	(27)	23
Provision for pensions	10	(52)	(171)
Other—net	(86)	(70)	66
	$(65)	$(95)	$ 90

Figure 1-4 (cont.)

Other—net includes a number of temporary differences such as those related to various portions of transactions involving business dispositions and restructuring expense provisions.

The U.S. investment tax credit (ITC) was repealed, with some transitional exceptions, effective January 1, 1986. ITC in 1986 and 1985 had aggregated $49 million and $111 million, respectively, and the amounts added to net earnings because of GE's deferral from prior years were $87 million in 1986 and $76 million in 1985. As a result of the accounting change in 1987, unamortized ITC is treated as a temporary difference for deferred tax accounting. Accordingly, $52 million was added to 1987 earnings before extraordinary item and cumulative effect of changes in accounting principles. The remaining unamortized ITC balance of $191 million (net of deferred tax) at year-end 1987 will be added to income in future years.

The U.S. federal statutory tax rate on corporations was 40% in 1987, down from 46% in each of the two previous years. GE's normal effective tax rate (provision for income taxes as a percentage of earnings before income taxes, extraordinary item and cumulative effect of changes in accounting principles) was 33.9% in 1987 compared with 32.5% in 1986 and 33.3% in 1985. A summary of reasons for differences between the statutory rate and GE's effective rate follows.

Differences Between U.S. Federal Statutory and GE Effective Tax Rates	*1987*	*1986*	*1985*
U.S. federal statutory rate	40.0%	46.0%	46.0%
Reductions in taxes resulting from:			
Inclusion of GEFS earnings (before extraordinary item and cumulative effect of accounting change) in consolidated before-tax income on an after-tax basis	(6.9)	(6.3)	(5.5)
Varying tax rates of consolidated affilites (principally foreign)	(3.7)	(2.2)	(3.6)
Investment tax credit	(2.7)	(2.3)	(2.2)
Income tax at capital gains rate	(0.6)	(1.4)	(0.2)
Varying rates on unusual items	0.8	(0.4)	(0.6)
Current-year effect of income tax accounting change	4.1	—	—
All other—net	2.9	(0.9)	(0.6)
GE effective tax rate	33.9%	32.5%	33.3%

Provision has been made for U.S. federal income taxes to be paid on that portion of the undistributed earnings of affiliates and associated companies expected to be remitted to the parent company. Undistributed earnings intended to be reinvested indefinitely in affiliates and associated companies totaled $1,318

Figure 1-4 (cont.)

million, $1,063 million and $964 million at the end of 1987, 1986 and 1985, respectively. It is estimated that foreign tax credits would approximately offset the U.S. taxes payable if these earnings were to be distributed.

Based on the location (not taxing jurisdiction) of the GE business providing goods or services, domestic income before taxes, extraordinary item and cumulative effect of changes in accounting principles was $2,690 million in 1987 ($3,081 million in 1986 and $3,232 million in 1985). The corresponding amounts for foreign-based operations were $517 million, $611 million and $188 million in each of the last three years, respectively.

General Electric Financial Services, Inc. (GEFS) is a nonconsolidated affiliate for financial reporting but is included in GE's consolidated U.S. federal income tax return. Taxes payable by the consolidated companies shown in this note exclude the effect of significant tax credits and deductions of GEFS, which arise primarily from leasing activities. GE and GEFS together had net taxes payable for 1987, 1986 and 1985. Existing leases of GEFS will generate taxable income in future years, which is provided for in the deferred income taxes of GEFS (see note 15). At December 31, 1987, 1986 and 1985, tax credit carryforwards totaling $168 million, $275 million and $358 million, respectively, were recorded by GEFS as a partial offset to deferred taxes. For financial reporting purposes, GEFS investment tax credit carryforward amounts are amortized to earned income over lease periods (as are investment tax credits currently usable). For tax purposes, they will be offset against taxes payable in the future.

8.2 Restatement

Amerada Hess Corporation's 1987 annual report illustrates the adoption of SFAS 96 by retroactively restating the financial statements of prior years, which resulted in a decrease of $201,818,000 in retained earnings at January 1, 1985 (see Figure 1-5).

In a footnote to its financial statements, Amerada Hess discloses the details of its provision for income taxes and the income on which it is based; the components of the provision for deferred taxes; a reconciliation of the statutory and effective tax rates; information on the undistributed earnings of foreign subsidiaries and their tax effects; and the details of operating loss carryforwards for tax and accounting purposes (see Figure 1-6).

Figure 1-5 *Statement of Consolidated Retained Earnings*
For the Years Ended December 31
(thousands of dollars, except per share data)

	1987	*1986**	*1985**
Balance at Beginning of Year			
As previously reported			$2,458,196
Adjustment to reflect change in method of accounting for income taxes			(201,818)
as restated	$1,758,445	$1,941,938	2,256,378
Net income (loss)	229,860	(182,570)	(222,111)
Dividends			
$3.50 cumulative convertible preferred stock	(831)	(1,085)	(1,217)
Common stock ($.45 per share in 1987 and $1.10 per share in 1985)	(37,396)	162	(91,112)
Redemption of preferred stock	(12,188)	—	—
Common stock acquired and retired	(41,677)	—	—
Balance at End of Year	$1,896,213	$1,758,445	$1,941,938

See accompanying notes to consolidated financial statements.

*Restated. See Note 2.

The Company explains this effect in a note to its Statement as follows:

Change in Accounting for Income Taxes

In December 1987, the Corporation changed its method of accounting for income taxes to comply with the provisions of FAS No. 96, Accounting for Income Taxes. The accounting change was applied retroactively by restating the financial statements of prior years, resulting in a decrease in retained earnings at January 1, 1985 of $201,818,000. The effect in 1987, 1986 and 1985 was to increase net income as follows:

Thousands of Dollars	*Amount*	*Per Share*
1987	$47,421	$.56
1986	36,873	.44
1985	38,298	.45

The effect of the accounting change in 1987 resulted principally from a revision in the estimated liability for deferred Petroleum Revenue Tax in the United Kingdom in the fourth quarter of the year. There was no material effect on the earlier quarters of 1987. Net income for each of the 1986 quarters increased as follows: first quarter—$8,208,000 ($.10 per share), second quarter—$2,492,000 ($.02 per share), third quarter—$6,450,000 ($.08 per share) and fourth quarter—$19,723,000 ($.24 per share).

Figure 1-6 *Amerada Hess Corporation*
Notes to Financial Statements
10. Provision for Income Taxes

The provision for income taxes consists of the following:

Thousands of dollars	*1987*	*1986**	*1985**
United States			
Federal**			
Current	$ 17,660	$ —	$ 12,972
Deferred	—	(10,881)	(93,352)
State	2,899	3,272	4,489
	20,559	(7,609)	(75,891)
Foreign			
Current	110,002	40,358	435,449
Deferred	(67,812)	(25,998)	44,368
Benefit of net operating loss carryforwards			
United States			
Current	(5,022)	—	—
Foreign			
Current	(39,005)	—	—
Deferred	—	(6,715)	(23,888)
	(44,027)	(6,715)	(23,888)
Adjustment of deferred tax liability for rate changes	4,268	(7,303)	(4,761)
Total	$ 22,990	$ (7,267)	$375,277

*Restated to reflect adoption of FAS No. 96.

**Income tax benefits on 1986 operating losses of U.S. operations (and certain foreign subsidiaries) have not been recorded, except to the extent of deferred tax credits arising from revision of prior year income tax estimates. No investment tax credits were recorded in 1987 and 1986. Investment tax credits amounted to $11,465,000 in 1985.

The provision for income taxes is based on income (loss) before income taxes as follows:

Thousands of dollars	*1987*	*1986*	*1985*
United States	$ (11,391)	$(271,830)	$ 76,507
Foreign*	264,241	81,993	613,351
Special charge			
United States	—	—	(513,032)
Foreign*	—	—	(23,660)
Total	$252,850	$(189,837)	$153,166

*Foreign income includes the Corporation's Virgin Islands, shipping and other operations located outside of the United States.

Figure 1-6 (cont.)

The provision for deferred income taxes is based on the liability method prescribed by FAS No. 96 and represents the change in the Corporation's deferred income tax liability during the year, including the effect of enacted tax rate changes. Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. A summary of the provision for deferred income taxes follows:

Thousands of dollars	*1987*	*1986*	*1985*
Depreciation	$ 6,079	$ 28,407	$ 38,330
Intangible drilling and related costs	(2,785)	(6,621)	4,607
Effect of foreign losses	—	(27,244)	—
Provision for excess shipping costs and related asset write-downs	—	—	(103,950)
Foreign petroleum revenue and other taxes	(73,956)	(23,044)	221
Revision of prior year estimates	—	(10,881)	—
Rate changes	4,268	(7,303)	(4,761)
Other items	2,850	(4,211)	(12,080)
Total	$ (63,544)	$ (50,897)	$ (77,633)

The difference between the Corporation's effective income tax rate and the United States statutory rate is reconciled below:

	1987	*1986*	*1985*
United States statutory rate	40.0%	(46.0)%	46.0%
Income from foreign operations subject to varying income tax levies	(7.5)	(16.7)	29.2
Losses for which no U.S. tax benefit was recorded	—	60.7	—
Investment tax credit and government grants	(9.4)	—	(1.7)
Net operating loss carryforwards	(17.4)	(3.5)	3.4)
Taxes related to prior years	4.7	—	—
Other items	(1.3)	1.7	(0.6)
Total	9.1%	(3.8)%	69.5%*

*Excluding effect of 1985 special charge. Inclusion of such special charge and related income tax benefit described in Note 3 would result in a 1985 effective income tax rate of 245%.

The Corporation has not recorded deferred income taxes applicable to undistributed earnings of foreign subsidiaries that are indefinitely reinvested in foreign operations. Undistributed earnings amounted to approximately $625 million at December 31, 1987, excluding amounts which, if remitted, generally would not result in any additional U.S. income taxes because of available foreign tax credits.

Figure 1-6 (cont.)

If the earnings of such foreign subsidiaries were not indefinitely reinvested, a deferred tax liability of approximately $148 million would have been required.

At December 31, 1987, the Corporation has a net operating loss carryforward for United States income tax purposes of approximately $380 million, expiring in the year 2001. Because of temporary differences, the operating loss carryforward for financial reporting purposes is approximately $450 million. The future benefit to be realized on utilization of net operating loss carryforwards may be affected by limitations on foreign tax credits and other factors.

The Corporation also has an investment tax credit carryforward of approximately $38 million, expiring in years through 2001.

Net operating loss carryforwards (expiring in years 1996 to 2001) applicable to certain foreign subsidiaries for income tax and financial reporting purposes at December 31, 1987 amount to approximately $270 million and $150 million, respectively.

The footnotes to Navistar International's financial statement for 1987 (see Figure 1-7) show restated as well as previously reported earnings, earnings-per-share figures, and other disclosures called for by SFAS 96. The company states that undistributed earnings of foreign subsidiaries have been permanently invested abroad and that any tax associated with the receipt of such earnings would be offset by NOL carryforwards. Also, loss carryforwards for both tax and financial reporting purposes are disclosed.

Figure 1-7 *Navistar International Corporation and Subsidiaries*
Note to Financial Statements
5. Income Taxes

The Company adopted Statement of Financial Accounting Standards No. 96 "Accounting for Income Taxes" ("SFAS 96"), in the fourth quarter of 1987. SFAS 96 provides that the manner of reporting tax benefits of operating loss carryforwards should be determined by the source of income in the current year. This change in accounting principle enables the Company to more clearly reflect the impact of net operating tax loss carryforwards on results of operations. Previously, these tax benefits were required to be reported as extraordinary income. Financial statements for prior periods have been restated to reflect this change in accounting principle, although there is no effect on net income (loss). There is no cumulative effect of this change on the Company's consolidated financial statements.

The following tables compare restated amounts to those amounts previously reported for certain Statement of Income classifications.

Figure 1-7 (cont.)

Millions of dollars except per share data	*1986* Restated Amount	Restated Per Share	Previously Reported Amount	Previously Reported Per Share
Income (loss) of continuing operations	$1.7	$(.14)	$(2.1)	$(.18)
Income (loss) before extraordinary item	$1.7	$(.14)	$(2.1)	$(.18)
Extraordinary item	—	—	3.8	.04
Net income (loss)	$1.7	$(.14)	$ 1.7	$(.14)

Millions of dollars except per share data	*1985* Restated Amount	Restated Per Share	Previously Reported Amount	Previously Reported Per Share
Income (loss) of continuing operations	$ 212.1	$ 1.54	$ 112.5	$ .77
Income (loss) before extraordinary item	$(363.6)	$(2.90)	$(463.2)	$(3.67)
Extraordinary item	—	—	99.6	.77
Net Income (loss)	$(363.6)	$(2.90)	$(363.6)	$(2.90)

The domestic and foreign components of income (loss) before income taxes consist of the following:

Millions of dollars	*1987*	*1986*	*1985*
Domestic	$107	$(30)	$(383)
Foreign	45	36	20
Total income (loss) before income taxes	$152	$ 6	$(383)

Taxes on income are comprised of the following:

Millions of dollars	*1987*	*1986*	*1985*
Tax (benefits) expenses provided before the effects of net operating losses:			
Consolidated companies	$ 44	$(35)	$ 31
Nonconsolidated companies	30	43	71
Tax benefits of net operating losses	(68)	(4)	(100)
Total taxes on income	$ 6	$ 4	$ 2

Figure 1-7 (cont.)

Taxes on income are analyzed by category as follows:

Millions of dollars	*1987*	*1986*	*1985*
Current:			
Federal	$48	$—	$ 85
Foreign	17	7	16
State and local	9	1	2
Total current	74	8	103
Deferred federal	—	—	(1)
Tax benefits of net operating losses	(68)	(40)	(100)
Total taxes on income	$ 6	$ 4	$ 2

The relationship of the tax (benefits) expenses to the pre-tax income (loss) in 1987, 1986 and 1985 differs from the U.S. statutory rate primarily because of losses in the U.S. and foreign countries for which only limited tax benefits are currently available. Consequently, an analysis of deferred taxes and variance from the statutory rate is not provided.

Undistributed earnings of foreign companies were $191 million at October 31, 1987. No taxes have been provided on $139 million of these undistributed earnings considered to be permanently reinvested. Substantially all tax expense associated with the receipt of such undistributed earnings would be offset by the utilization of net operating loss carryforwards.

At October 31, 1987, the Company's continuing operations had an estimated $1,386 million of domestic and $16 million of foreign net operating loss carryforwards, for a total of $1,402 million, available to reduce future taxable income. Of this amount, $8 million is available from 1988 through 1993, $848 million through 1998, $363 million through 2000, $174 million through 2002, and $9 million is available for an indefinite number of years. For financial reporting purposes, the Company had a net operating loss carryforward of $2,172 million available to reduce financial income at October 31, 1987. Substantially all of the $770 million difference between the tax and financial loss carryforwards will not expire earlier than the year 2003.

The Company has domestic investment tax credit carryforwards of approximately $41 million at October 31, 1987 which are available to reduce future U.S. federal tax liabilities. Such carryforwards expire in fiscal years ending 1992 through 2001, if not previously utilized.

9. ALTERNATIVE MINIMUM TAX

An alternative to the "regular" tax system, the alternative minimum tax (AMT) is viewed as a comprehensive tax system in which the higher outcome of the calculation determines the actual tax liability. The alternative system should be used to measure an enterprise's deferred tax asset or liability in a manner consistent with the tax law.

After considering any interaction between the two systems, such as the AMT credit, the deferred tax asset or liability is recognized based on the results of the two calculations for each future year.

Existing temporary differences may be recognized or measured differently under each of the two tax systems, and a temporary difference may exist for only one system because of different recognition or measurement provisions.

The AMT credit, which has an indefinite life, can be used to reduce only a certain portion of regular tax owed in future years. It can also be used within the limitations set forth in SFAS 96 as an offset to originating and existing deferred tax credits. However, any remaining AMT credit may not be recognized as a deferred tax asset.

The amount of a deferred tax liability to be recognized under SFAS 96 should be based on the higher of the regular tax and AMT calculations of the deferred tax liability.

Beginning with taxable years after December 31, 1989, the financial reporting income adjustment will be replaced by an adjusted current earnings (ACE) computation, which essentially is the same as Subchapter C Earnings and Profits, with certain adjustments. Under the U.S. Tax Code, the ACE adjustment is 75 percent of the amount by which ACE exceeds the AMT income (AMTI), exclusive of the ACE adjustment and any AMT NOL deduction.

The AMT NOL deduction may not exceed 90 percent of AMTI before the deduction. The AMT NOL is the same as the regular tax NOL, only it is reduced by preference items included in the loss and modified for any adjustments.

The tax law allows the excess of the TMT over the regular tax, with some adjustment, as a tax credit to be carried forward indefinitely and to reduce regular tax, but not AMT, liabilities. The minimum tax credit consists of that portion of the AMT attributable to deferral items, as opposed to such exclusion items as preferences.

9.1 Minimum Tax Credit

The following illustrates the computation of the minimum tax credit:

Regular taxable income		$ 820,000
Deferral items		1,562,000
Preference items		18,000
AMTI		2,400,000
TMT	Rate: 20 percent AMTI	480,000
	Regular tax ($820,000 × 34 percent)	278,800
	AMT	$ 201,200
AMT	Credit	
	Regular taxable income	$ 820,000
	Preference items	18,000
		838,000
TMT	Rate: (20 percent × $838,000)	167,600
	Regular tax	278,800
AMT	Without deferral preferences	-0-
Minimum tax credit carryforward against future years' regular tax liability		$ 201,200

It is beyond the scope of this chapter to discuss the details of the AMT. Certain basic principles are needed, however, to understand the following case illustrating the interaction among the regular tax, AMT, and deferred income taxes. The computation is as follows:

9.2 Determination of AMT

Beginning with regular taxable income (add back the NOL deduction), follow these steps:

- *Add:* AMT preference items, that is, amounts related to the preference component of percentage depletion; intangible drilling costs; charitable contributions of appreciated property; private-activity, tax-exempt interest; and accelerated depreciation on certain property placed in service before January 1, 1987.
- *Add or deduct:* Adjustments for items treated differently for the AMT are effects of depreciation on post-1986 assets, and alternative

accounting for circulation expenditures; mining exploration and development; long-term contracts; installment sales; passive activity losses; and certain other items.

Tentative AMT Income

- *Add:* Book income adjustment (50 percent of the adjusted financial reporting income − tentative AMT income).*
- *Deduct:* AMT NOL deduction not to exceed 90 percent of AMTI before the deduction. (AMT NOL must be reduced for preference items.)

AMT income × AMT rate − 20 percent**

TMT (Less foreign tax credits, 90-percent limit, and the ITC carryover, 25-percent limit.) Overall: 90-percent limit.

- *Deduct:* Regular tax.

AMT

*Adjusted financial reporting income is based on income reported in the enterprise's financial statements, with a priority ordering governing the use of financial statements, i.e., SEC filings, certified statements, and so forth, and includes adjustments. Book income must take into account all items of income, expense, gain, and loss for the year, including extraordinary items; cumulative adjustments resulting from accounting changes; and prior period adjustments to retained earnings.

Adjust book income by such items as:

- *Income taxes*—Eliminate federal and foreign taxes, except foreign taxes pre-deducted for income tax purposes. Any item reflected in the financial statement net-of-tax should be grossed up.
- *Disclosures*—Book income must be increased by amounts disclosed in footnotes or in other supplementary information if disclosure results in a greater amount of book income. (This excludes disclosure authorized by GAAP or reflecting "historic practice.")
- *Cumulative effect*—Exclude amounts attributable to years before 1987.
- *Related corporations*—Adjust so that financial statements conform and reflect applicable members.

**The rate is 20 percent on AMTI in excess of $40,000 if the AMT is higher than regular tax. The $40,000 exemption is reduced by 25 percent of AMTI over $150,000 and entirely phased out when AMTI reaches $310,000.

Case 12 illustrates the interaction of the regular tax, AMT, and deferred income taxes.

Case 12. Determination of deferred tax liability and provision for income tax—application of AMT

The enterprise is a U.S. enterprise whose tax liability is determined based on the Tax Reform Act of 1986. A 35-percent tax rate of regular taxable income is assumed for all years. Additional assumptions are as follows:

- The current year, Year 1, is the enterprise's first year of operations.
- The enterprise has tax-exempt income of $2,600 from municipal bonds (nonpreference) in the current year.
- U.S. tax law provides that the book income adjustment, a feature of the AMT system, will be replaced by an adjustment for ACE; that change is assumed to occur in Year 5.
- Depreciable assets that cost $2,000 were acquired in the middle of the current year and will be depreciated as follows:

			Depreciation	
	Financial Reporting	*Regular Tax Depreciation: 40 percent*	*AMT: 30 percent*	ACE
Year 1	$ 200	$ 400	$ 300	
Year 2	400	640	510	
Year 3	400	384	356	
Year 4	400	230	334	
Year 5	400	230	334	$ 250
Year 6	200	116	166	250
	$2,000	$2,000	$2,000	$ 500

Financial income and income taxes currently payable for the current year are as follows:

Regular Tax Calculation:	
Pretax financial income	$4,000
Municipal bond income	(2,600)
Depreciation difference	(200)
Regular taxable income	$1,200
Regular tax (35 percent)	$ 420

AMT Calculation:

Regular taxable income	$1,200
Depreciation adjustment [Difference between regular tax and AMT depreciation ($400 − 300)]	100
Tentative AMTI	$1,300
Book income adjustment [50% of ($4,000 − 1,300)]*	1,350
AMTI	$2,650
Tentative minimum tax (TMT) (20%)	$ 530
Income taxes currently payable	$ 530

*The book income adjustment is equal to one-half of the amount by which pretax financial income exceeds tentative AMTI. No book income adjustment is made in years in which tentative AMTI exceeds pretax financial income.

The enterprise's current tax liability will be $530 (regular tax $420 plus $110 AMT). In this example, the tax law permits, within certain limitations, the excess of the TMT over the regular tax ($110) to be carried forward and used as a credit against the regular tax in future years. However, the AMT credit can only be carried forward and cannot be used to reduce a future year's regular tax below the TMT for that future year.

At the end of Year 1, the current year, a liability for the deferred tax consequences of depreciation differences is calculated as shown in Exhibit 1-12 (amounts are rounded to the nearest dollar).

Temporary differences between financial reporting depreciation and regular tax depreciation appear in Exhibit 1-12, line 1. The $(240) deductible amount is carried back to Year 1. Deferred tax on a regular tax basis appears on line 4. The $(84) item in Year 1 is the benefit of the loss carryback at the 35-percent rate.

The computation of deferred taxes on an AMT basis appears on lines 5 through 13. The tentative AMTI is the difference between the regular taxable temporary depreciation differences, line 5, and the AMT depreciation adjustment, line 6. In essence, line 7 represents the temporary depreciation differences arising from the excess of financial reporting depreciation over AMT depreciation.

The book income adjustment, line 8, applies only if book income is higher than tax income. The book income adjustment does not apply in Year 1 because of the loss carryback. In Year 2, the book income adjustment is $55 because the zero book income (SFAS 96 assumes a break-even in future years) is greater than the TAMT I loss of $(110). The ACE adjustment for Years 5 and 6 is 75 percent of the amount by which ACE exceeds AMTI, exclusive of the ACE adjustment and any AMT NOL deductions (see Exhibit 1-12a). The ACE adjustment appears on line 9 of Exhibit 1-12.

The AMT (NOL) may not exceed 90 percent of the AMTI before the deduction. There is no limit here because the AMTI in Year 1 is $2,650, whereas the NOL is $(55). The AMT NOL ($55) is the same as the regular tax NOL ($240), reduced by preference items included in the loss and modified for any adjustments. The loss carryback to Year 1 results in—

- An $84 reduction in regular tax (line 4).
- An $11 reduction in TMT (line 13).
- A $73 increase in AMT carryforward ($84 − $11) (line 18).
- The carryforward at the end of Year 1 is $183 (line 19) and consists of the $110 carryforward arising in Year 1 (TMT $530—regular tax $420) and the $73 resulting from the Year 2 loss carryback.
- The AMT credit carryforward of $183 does not change in Year 2 but is carried forward to Year 3.

The higher of the regular tax or AMT appears on line 14. The AMT credit carryforward is used in Year 3 to reduce the regular tax of $6 to $3, an amount that is both the AMT and the deferred tax liability (lines 15 and 16). As a result, the carryforward is reduced to $180 at the end of Year 3. The AMT carryforward continues to reduce the deferred tax liability but not below the AMT.

Based on the scheduling in Exhibit 1-12, the deferred tax liability in Year 1 is $31 (line 16).

Exhibit 1-12 *Calculation of Deferred Income Tax Under Regular Tax and Alternative Minimum Tax (AMT)*

	Carryback to Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*
Regular Tax Calculation:						
1. Taxable (deductible) amounts	$ —	$(240)	$ 16	$ 170	$ 170	$ 84
2. Loss carryback	$(240)	(240)	—	—	—	—
3. Regular taxable amounts	$(240)	—	$ 16	$ 170	$ 170	$ 84
4. Regular tax (35%)	$ (84)	$ —	$ 6	$ 60	$ 60	$ 30

Exhibit 1-12 (cont.)

	Carryback to Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
AMT Calculation:						
5. Regular taxable amounts before loss carryback and carryforward	$ —	$(240)	$ 16	$ 170	$ 170	$ 84
6. AMT depreciation adjustment	$ —	130	28	(104)	(104)	(50)
7. TentativeAMTI	—	(110)	44	66	66	34
8. Book income adjustment*	—	55	—	—	—	—
9. ACE adjustment**	—	—	—	—	64	(64)
10. AMTI before loss carryback	—	(55)	44	66	130	(30)
11. Loss carryback	(55)	55	(30)	—	—	30
12. AMTI	$ (55)	$ —	$ 14	$ 66	$ 130	$ —
13. TMT (20%)	$ (11)	$ —	$ 3	$ 13	$ 26	$ —
14. Higher of regular tax or TMT	$ (11)	$ —	$ 6	$ 60	$ 60	$ 30
15. AMT credit carry-forward applied	—	—	3	47	34	30
16. Deferred tax liability of $31	$ (11)	$ —	$ 3	$ 13	$ 26	$ —
AMT Credit Carryforward:						
17. Beginning of year	$ 110	$ 183	$ 183	$ 180	$ 133	$ 99
18. Add (deduct)	73	—	(3)	(47)	(34)	(30)
19. End of year	$ 183	$ 183	$ 180	$ 133	$ 99	$ 69

*Financial income in future years under SFAS 96 is zero, therefore, the book income adjustment is $55 because the zero book income is greater than the TAMTI of $(110).

**The ACE adjustment is equal to 75 percent of the difference between tentative AMTI and ACE. Unlike the book income adjustment, the ACE adjustment, subject to certain limitations, can result in deductible or taxable amounts. In this example, it is assumed that depreciation is the only reason for differences among pretax financial income, regular taxable income, tentative AMTI, and ACE.

Exhibit 1-12A *Calculation of ACE Adjustment (line 9)*
(Line 9 from Exhibit 1-12)

The ACE adjustments for Years 5 and 6 are calculated as follows:

	Year 5	*Year 6*
Regular taxable amounts	$ 170	$ 84
ACE depreciation adjustment	(20)	(134)
ACE	150	(50)
Tentative AMTI	66	34
ACE less tentative AMTI	$ 84	$ (84)
75 percent of difference	$ 64	$ (64)

10. SEC STAFF ACCOUNTING BULLETIN NO. 74

SEC Staff Bulletin No. 74, entitled "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrants When Adopted in a Future Period," expresses the staff's view concerning disclosures that generally should be provided by a registrant when an accounting standard has been issued but not yet adopted.

The staff's view is this: If the impact is expected to be material, filings should include disclosure of the impact that the recently issued accounting standard would have when adopted on the registrant's financial position and operations. This finding is in accordance with existing Management's Discussion and Analysis requirements.

In general, the registrant should consider the following disclosure measures:

- A brief description of the new standard, the date when adoption is required, and, if earlier, the date when the registrant plans to adopt the standard
- A discussion of the adoption methods allowed by the standard and the method the registrant expects to use, if determined
- A discussion of the impact that adoption of the standard is expected to have on the registrant's financial statements, unless it is not known or cannot be reasonably estimated. In that case, a statement to that effect may be made

Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard, such as technical violations of debt covenant agreements, or planned or intended changes in business practices, is also encouraged.

11. SOME CONSIDERATIONS ON THE ADOPTION OF SFAS 96

The following are some considerations regarding the adoption of SFAS 96:

- Identify the periods in which the temporary differences will reverse.
- Identify the temporary differences for which tax-planning strategies can and cannot be applied.
- Identify the nature of temporary differences, that is, differences that would give rise to taxable reversals enabling the use of foreign tax credits or capital gains carryforwards.
- Any cushion for future tax examinations belongs in the current tax account.
- Identify other basis differences—business combinations or depreciable assets whose tax bases were reduced due to tax credits.
- Determine tax-planning strategies.
- Consider an adoption date: December 31, 1989 or 1990.

The new rules will have to be applied to years beginning after December 15, 1989 (calendar 1990), with optional restatement of prior years (see effective date).

Note that, under the Tax Reform Act of 1986, tax rates will drop and corporations with net deferred tax credits may wind up with a credit to income on the adoption of SFAS 96.

On the other hand, corporations with net prepaid taxes may find they have a charge against income on adoption, unless they have a carryback availability. This effect would result because, under SFAS 96, the recognition of deferred tax assets is much more limited.

Here are some other matters to consider:

- Under current practice, deferred taxes often are not provided on gains reported by a parent company when a subsidiary issues common stock to the public. However, SFAS 96 would require a provision for deferred tax because it eliminates exceptions analogous to APB 23 items.

- Application of the liability method will make it essential to develop a tax-basis balance sheet for each tax jurisdiction.

In general, to determine the optimal date and method of adoption, a registrant should consider the following:

- The impact of the alternative transition methods on both current earnings and earnings trends
- The effect on shareholders' equity, current ratio, and debt/equity ratio, including any related loan convenants
- The availability of information necessary to restate prior periods
- Possible near-term changes in tax laws and rates
- How much lead time is needed to obtain necessary information

APPENDIX A
Comparison of SFAS 96 and APB Nos. 11, 23, and 24

Provision	SFAS 96	*Present Rules/APB 11*
Concept of accounting for income taxes	Comprehensive recognition of deferred taxes.	Same.
Exceptions	Continues same exceptions to income tax allocation.	Exceptions for deposits in statutory reserve funds by U.S. steamship companies and APB 23 items.
Focus	Accruing asset or liability for future tax return consequences of temporary differences.	Income statement matching of initial tax effects of timing differences and related pretax amounts.
Method	Liability method—Tax rates applied to cumulative temporary differences based on expected impact of differences on future tax returns.	Deferred method—Tax rates of the year in which timing differences arise are used to estimate tax effects.
Effect of change in tax rates	Deferred tax balance is adjusted for a change in tax rates, and effect is allocated to income from continued operations.	No effect given to change in tax rate.
Measurement and recognition	Deferred taxes computed as though a tax return were prepared for the net amount of temporary differences that will result in taxable or deductible amounts in each future year.	Tax effects measured by the differential between income taxes computed with and without inclusion of the transaction, creating the timing difference. Gross or net change method.
Deferred tax asset	Recognize a deferred tax asset for net deductible amounts that could be realized by loss carryback from future years to reduce taxes in the current or a prior year. No asset is	Recognized based on the results of the deferred tax calculations, subject only to a reasonable-likelihood-of-realization test.

Provision	*SFAS 96*	*Present Rules/APB 11*
	recognized for additional net deductible amounts in future years.	
Benefit of operating loss carryforwards	Can deduct operating loss carryforward for tax purposes from net taxable amounts scheduled to occur in future years included in the loss carryforward period (i.e., to reduce a deferred tax liability). Unrecognized amounts of carryforwards are treated as a reduction of income tax expense when realized and are reported in the same manner as the source of income that permits the use of the carryforward.	Recognized as an asset if realization is assured beyond a reasonable doubt in the year of the loss. Otherwise, the benefit can offset deferred tax credits. Previously unrecognized carryforward is treated as an extraordinary item when realized.
Discounting	No discounting.	Prescribed by APB 10 (but is applied in purchase business combinations).
Tax-planning strategies	May be considered in determining the timing of the reversal of temporary differences.	Applicable only to indefinite reversal items.
Business combinations	A tax liability or asset is recognized for differences between the tax basis and assigned values of the net assets of the acquired enterprise.	In purchase combinations, net-of-tax values are assigned to the assets and liabilities of the acquired enterprise.
	Realization of operating loss carryforward is accounted for first by reducing to zero positive goodwill and other noncurrent acquired intangible assets (other than marketable equity securities), and then reducing income tax expense.	If recognized when realized after the purchase, then restate the purchase transaction. Reduce positive goodwill to zero, then noncurrent assets are reduced, and any additional amounts are negative goodwill.

Provision	*SFAS 96*	*Present Rules/APB 11*
Intercompany tax allocation	No prescribed principles.	Same.
Intraperiod allocation	Allocate to income from continuing operations, extraordinary items, discontinued operations, cumulative effect of accounting change, and equity accounts.	Same.
Disclosure balance sheet classification of deferred tax	Classification depends on when the temporary differences reverse.	Classified the same way as related assets and liabilities.

APPENDIX B

Key Definitions from SFAS 96

Deferred tax asset. The amount of deferred tax consequences attributable to temporary differences that will result in net tax deductions in future years which could be recovered (based on loss carryback provisions in the tax law) by refund of taxes paid in the current or a prior year. Recognition and measurement of a deferred tax asset does not anticipate the tax consequences of income that might be earned in future years.

Deferred tax consequences. The future effects on income taxes (as measured by the provisions of enacted tax laws) resulting from temporary differences at the end of the current year, without regard to the effects of events not yet recognized or inherently assumed in the financial statements.

Deferred tax expense (benefit). The net change during the year in an enterprise's deferred tax liability or asset.

Deferred tax liability. The amount of deferred tax consequences attributable to temporary differences that will result in net taxable amounts in future years. The liability is the amount of taxes payable on those net taxable amounts in future years, based on tax law provisions. Recognition and measurement of a deferred tax liability does not anticipate the tax consequences of losses or expenses that might be incurred in future years.

Gains and losses included in comprehensive income but excluded from net income. Under present practice, this category includes: certain changes in market values of investments in those marketable equity securities classified as noncurrent assets; certain changes in market values of investments in industries having specialized accounting practices for marketable securities; adjustments resulting from the recognition of certain additional pension liabilities; and foreign currency translation adjustments. Future changes to GAAP may change what is included in this category.

Income tax expense (benefit). The sum of current tax expense (benefit) and deferred tax expense (benefit).

Operating loss carryback or carryforward for tax purposes. An excess of tax deductions over gross income during a year, which may be carried back or forward to reduce taxable income in other years. Different tax jurisdictions have different rules about whether or not an operating loss may be carried back or forward as well as about the length of the carryback or carryforward period. The discussion and examples in SFAS 96 assume that the tax law requires an operating loss to first be carried back for up to three years, then forward up to 15 years. In this Statement, this term is also intended to include carrybacks or carryforwards for individual deductions that exceed statutory limitations.

Operating loss carryforward for financial reporting purposes. The amount of an operating loss carryforward for tax purposes is (a) reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward and (b) increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

Statutory limitations. Provisions in the tax law that limit the amount by which certain deductions or tax credits can be applied to reduce taxable income or income taxes payable.

Tax credit carryback or carryforward for tax purposes. Tax credits that exceed statutory limitations and may be carried back or forward to reduce taxes payable in other years. Different tax jurisdictions have different rules regarding whether or not a tax credit may be carried back or forward as well as on the length of the carryback or carryforward period.

Tax credit carryforward for financial reporting. The amount of a tax credit carryforward for tax purposes, reduced by the amount recognized as a reduction of a deferred tax liability for temporary differences that will result in net taxable amounts during the tax credit carryforward period.

Tax-planning strategy. A transaction or series of transactions that meets certain criteria and would, if implemented, affect the particular future years in which temporary differences result in taxable or deductible amounts. A tax-planning strategy, including elections for tax purposes that are required or permitted by the tax law, either reduces the amount of a deferred tax liability or increases the amount of a deferred tax asset that would otherwise be recognized.

Temporary difference. A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years, when the reported amount of the asset or liability is recovered or settled, respectively. Some temporary differences cannot be identified with a particular asset or liability for financial reporting, but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amount in future years based on provisions in the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation, and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

APPENDIX C

Financial Statements and Notes Checklist for Income Taxes

Following are selected questions pertinent to Statement of Financial Accounting Standards No. 96. These items are extracted from the *AICPA Auditing and Accounting Manual,* Section 8400, "Disclosure Checklists for Corporations." These items are not all-inclusive and are not intended to present minimum requirements.

	Yes	*No*	*N/A*
1. If significant, has the amount of net operating loss or tax credit carryforwards for which any tax benefits will be applied to reduce goodwill and other noncurrent assets (of an acquired enterprise) been disclosed separately? [SFAS 96, par. 29 (AC I25.128)]	—	—	—
2. If financial statements for prior years are restated, have all purchase business combinations that were consummated in those prior years been remeasured in accordance with the requirements of SFAS 96 (AC section I25)? [SFAS 96, par. 25]	—	—	—
3. Are income tax effects for unrealized gains or losses on marketable securities recognized in conformity with SFAS 96? [SFAS 96 (AC I25)]	—	—	—
4. Have deferred tax assets been recognized for the net tax benefit of net deductible amounts that could be realized by loss carryback from future years:			
a. To reduce a current deferred tax liability?	—	—	—
b. To reduce taxes paid in the current or a prior year? [SFAS 96, par. 17e (AC I25.116e)]	—	—	—
5. Have deferred tax assets been adjusted for the effect of a change in tax law or rates with the effect included in income from continuing operations for the period that includes the enactment date? [SFAS 96, par. 20 (AC I25.119)]	—	—	—
6. Have deferred tax assets attributable to different tax jurisdictions been presented separately and not offset? [SFAS 96, par. 24 (AC I25.123)]	—	—	—
7. Have the types of temporary differences that give rise to significant portions of a deferred tax asset been disclosed? [SFAS 96, par. 24 (AC I25.123)]	—	—	—

	Yes	No	N/A
8. Have deferred tax assets been classified in two categories—the current amount and the noncurrent amount—in a classified statement of financial position?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			
9. Is the current amount of a deferred tax asset the net deferred tax consequence of:			
a. Temporary differences that will result in net taxable or deductible amounts during the next year?	—	—	—
b. Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year?	—	—	—
c. Temporary differences for which there is no related identifiable asset or liability for financial reporting (SFAS 96, par. 12 [AC I25.111]) whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			
10. Have deferred tax liabilities been recognized for temporary differences that will result in net taxable amounts in future years?	—	—	—
[SFAS 96, par.1 7f-h (AC I25.116f-h)]			
11. Has a deferred tax liability been adjusted for the effect of a change in tax law or rates with the effect included in income from continuing operations for the period that includes the enactment date?	—	—	—
[SFAS 96, par. 20 (AC I25.119)]			
12. Have deferred tax liabilities attributable to different tax jurisdictions been presented separately and not offset?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			
13. Have the types of temporary differences that give rise to significant portions of a deferred tax liability been disclosed?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			
14. Have deferred tax liabilities been classified in two categories—the current amount and the noncurrent amount—in a classified statement of financial position?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			

	Yes	No	N/A
15. Is the current amount of a deferred tax liability the net deferred tax consequence of:			
a. Temporary differences that will result in net taxable or deductible amounts during the next year?	—	—	—
b. Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year?	—	—	—
c. Temporary differences for which there is no related identifiable asset or liability for financial reporting (SFAS 96, par. 12 [AC I25.111]) whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year?	—	—	—
[SFAS 96, par. 24 (AC I25.123)]			
16. Has the following information been disclosed whenever a deferred tax liability is not recognized for any of the areas addressed by APB 23 [AC I25 & I42] or for deposits in statutory reserve funds by U. S. steamship enterprises:			
a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable?	—	—	—
b. The cumulative amount of each type of temporary difference?	—	—	—
c. The amount of the unrecognized deferred tax liability for any unremitted earnings if determination of that liability is practicable or a statement that determination is not practicable and the amount of withholding taxes that would be payable upon remittance of those earnings?	—	—	—
d. The amount of the unrecognized deferred tax liability for temporary differences other than unremitted earnings (that is, the bad debt reserve of a stock or mutual savings and loan association or a mutual savings bank, the policy holders surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. Steamship enterprise)?	—	—	—
[SFAS 96, par. 25 (AC I25.124)]			
17. Has the fact that the entity is a public enterprise that is not subject to income taxes because its income is taxed			

	Yes	No	N/A
directly to its owners and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities been disclosed? [SFAS 96, par. 24 (AC I25.123)]	___	___	___
18. Has the amount of income tax expense or benefit been allocated to:			
a. Continuing operations?	___	___	___
b. Discontinued operations?	___	___	___
c. Extraordinary items?	___	___	___
d. The cumulative effect of accounting changes?	___	___	___
e. Prior period adjustments?	___	___	___
f. Gains and losses included in comprehensive income but excluded from net income?	___	___	___
g. Capital transactions? [SFAS 96, par. 26 (AC I25.125)]	___	___	___
19. Have the following significant components of income tax expense attributable to continuing operations for each year presented been disclosed in the financial statements or notes thereto:			
a. Current tax expense or benefit?	___	___	___
b. Deferred tax expense or benefit exclusive of (f) below?	___	___	___
c. Investment tax credits?	___	___	___
d. Government grants (to the extent recognized as a reduction of income tax expense)?	___	___	___
e. The benefits of operating loss carryforwards?	___	___	___
f. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise? [SFAS 96, par. 27 (AC I25.126)]	___	___	___
20. Has the nature of significant reconciling items been disclosed? [SFAS 96, par. 28 (AC I25.127)]	___	___	___
21. Have the amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards for financial reporting (that is, amounts not already recognized as reductions of a deferred tax liability) and for tax purposes (that is, amounts available to reduce taxes payable on tax returns in future years) been disclosed? [SFAS 96, par. 29 (AC I25.128)]	___	___	___

	Yes	No	N/A
22. If the enterprise is part of a group that files a consolidated tax return, have the following items been disclosed in its separately issued financial statements:			
a. The amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented?	—	—	—
b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented?	—	—	—
[SFAS 96, par. 30 (AC I25.129)]			
23. For the earliest year restated or for the year SFAS 96 [AC I25] is first adopted if no prior year is restated, has the effect of applying SFAS 96 on the amount of deferred tax charges or credits at the beginning of the fiscal year been reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, except for any effects of the type required by SFAS 96 to be excluded from net income?	—	—	—
[SFAS 96, par. 33]			
24. When initially presented, have the financial statements for the year SFAS 96 [AC I25] is first adopted, disclosed the following:			
a. The effect of adopting SFAS 96 [AC I25] on income from continuing operations, income before extraordinary items, and on net income for the year of adoption if restated financial statements for the prior year are not presented?	—	—	—
b. The effect of any restatement on income from continuing operations, income before extraordinary items, and on net income for each year presented?	—	—	—
[SFAS 96, par. 34)			

CHAPTER 2

Accounting for Cash Flows

(FASB Statement No. 95)

CHAPTER 2

Accounting for Cash Flows

(FASB Statement No. 95)

1. INTRODUCTION

Statement of Financial Accounting Standards (SFAS) No. 95, *Statement of Cash Flows*, November 1987, establishes standards for presenting a statement of cash flows as part of general purpose financial statements. The new pronouncement supersedes Accounting Principles Board (APB) Opinion No. 19, *Reporting Changes in Financial Position*, and requires business enterprises to substitute a statement of cash flows for the statement of changes in financial position. In addition, firms must separately present information about noncash investment and financing transactions. In preparing a complete set of financial statements, the statement of cash flows is required for each period for which the results of operations are provided.

Under current practice, there is considerable diversity in the definition of funds, for example, cash, cash and short-term investments, short-term investments, or both, as well as quick assets and working capital. SFAS 95 reduces this diversity by requiring the statement of cash flows to focus on cash and cash equivalents and by requiring disclosure of the cash components.

While not-for-profit organizations are excluded from the scope of this Statement, financial institutions and investment companies are subject to SFAS 95 requirements.

2. CASH EQUIVALENTS

2.1 Definition of Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are both readily convertible to cash and so near maturity that fluctuations in interest rates generally result in insignificant risk of changes in investment values. In contrast, cash includes currency and other accounts that have characteristics of demand deposits. Cash equivalents result from funds temporarily invested to earn interest and not to take advantage of interest rate changes or other factors. Items typically considered to be cash equivalents include treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations).

Only investments with original maturities of three months or less qualify as cash equivalents. The acquisition of a treasury note with a remaining life of three months would also qualify under the definition. However, a previous investment in a three-year old treasury note with a remaining life of three months does *not* qualify. Nor are investments in equity securities considered to be cash equivalents.

2.2 Disclosure and Presentation of Cash Equivalents

A firm must disclose policies used to determine which investments are cash equivalents. Note that changing the definition of cash equivalents is considered to be an accounting method change, requiring the retroactive restatement of previous years' financial statements presented with the current year's statements for comparative purposes.

The total amount of beginning- and end-of-the-period cash and cash equivalents shown in the statement of cash flows must correspond to a similarly titled item or subtotal in the statement of financial position.

3. CLASSIFICATION OF CASH FLOWS

Cash receipts and cash payments are to be classified into investing, financing, or operating activities. SFAS 95 provides specific definitions for investing and financing activities. Activities not considered to be investing or financing are then categorized as operating activities. This format enables users to assess significant relationships within each activity group as well as among the three kinds of activities. The source-and-use format is no longer appropriate.

Investing activities include—

- Lending money and collecting on loans.
- Acquiring and selling (disposing of) property, plant and equipment, and other productive assets.
- Acquiring or selling debt or equity instruments.

Financing activities include—

- Obtaining resources from owners and providing a return on, and a return of, the investment of such resources.
- Borrowing money and repaying (settling) the obligations.
- Obtaining and paying for other resources acquired on long-term credit.

Operating activities include—

- All transactions and other events that are not investing and financing activities.
- Delivery or production of goods for sale and services provided.
- Generally, cash effects of transactions entering into income.

3.1 Components of Cash Flows From Operating Activities

Cash flows from operating activities are the cash effects of transactions and other events that bear upon income determination. Interest received on loans, and dividends received on equity securities, are included in cash flows from operating activities, although they are investment-related. Interest paid on loans is included as a cash flow from an operating activity, although the expenditure itself is finance-related. However, capitalized interest is part of the cost of the nonmonetary asset and is treated as investment-related.

All taxes paid are treated as operating cash flows. Allocation of taxes among activities is considered to be arbitrary and, therefore, is not required.

3.2 Additional Classification Guidance

If a cash inflow or outflow relates to more than one activity category, the classification will be determined according to the predominant source of cash flow for that item. For instance, the acquisition, production, and sale of equipment used or rented by a firm is generally investment-related. This presumption is overcome, however, if such equipment is used or rented for a short period and then sold. Under such circumstances, the acquisition or production of such an asset as well as the subsequent sale are all classified as operating activities.

All cash collected from customers or paid to suppliers, including cash arising from installment sales, is classified as an operating cash flow. This is a change from the exposure draft, which treated only those cash flows occurring soon after a sale or purchase as an operating activity.

Each cash flow is classified according to its nature, even if it is intended as a hedge. For example, the purchase or sale of a futures contract is an investing activity, regardless of whether that contract is intended to hedge a firm commitment or purchase inventory.

Gains and losses resulting from the redemption of a firm's own debt are financing-related and are categorized as cash flows related to the retirement of outstanding debt.

Gains and losses resulting from asset disposals are investment-related. Receipts from the disposal of property, plant, or equipment include the proceeds of an insurance settlement.

Advance payments on the purchase of productive assets are considered to be investing cash flows. Any debt to the seller of the productive asset is a financing transaction.

All principal payments on mortgages, including those on seller-financed or debt on productive assets, are classified as financing cash flows.

4. GROSS AND NET CASH FLOWS

Ordinarily, information about the gross amounts of cash receipts and cash payments is presented for each period. For example, the change in property, plant, and equipment during a period is separately reported as (a) cash payments for new equipment and (b) cash proceeds on the disposal of property, plant, and equipment.

4.1 Exceptions

Netting cash receipts and disbursements provides sufficient information for certain classes of cash flows, and is appropriate when—

- Cash flows are related to the temporary investment of cash in short-term, highly liquid investments (that is, cash equivalents). These temporary investments are cash-management procedures and are not considered to be operating, financing, or investing activities. They are merely shifts between different forms of cash. The terms *cash* and *cash equivalents* rather than *funds* are used to describe such net flows from temporary investments.

- Items other than cash and cash equivalents relating to investments, loans receivable, and debt situations in which turnover is quick, the amounts are large, and the maturities are short. To qualify for netting, investments, loans, and debt must have an original maturity of three months or less. For a commercial entity, examples of when netting might be appropriate include revolving credit arrangements and commercial paper obligations. Were it not for this netting exception, an enterprise that issues seven-day commercial paper and rolls it over every week would report financing cash inflows and outflows four times greater than those of an enterprise issuing a one-month paper. In addition, demand deposits of a bank, customer accounts payable of a broker-dealer, and credit card operations of a financial services business may also be netted.
- Companies employing the indirect approach to present cash flows from operations should net operating activities.

5. GUIDANCE ON STATEMENT PRESENTATION

The statement of cash flows for a period reports separately the net cash provided for or used by operating, investing, and financing activities. The cash flows reconcile beginning and ending amounts of cash and cash equivalents. Separate disclosure of cash flows pertaining to extraordinary or discontinued items is no longer required.

The new Statement permits the use of either the direct or indirect method of presenting cash flows from operating activities. However, firms are encouraged to present cash flows from operating activities using the direct method.

5.1 Direct Method

This method involves showing the major classes of operating cash receipts (cash collected from customers or earned on investments) and cash payments (cash paid to suppliers or to creditors for interest). The net cash flow from operating activities is the difference between cash received from operations and cash payments for operations.

5.1.1 Items Separately Reported Under Direct Method

Firms reporting under the direct method are required to report separately the following classes of operating cash receipts and payments:

- Cash collected from customers, including lessees and licensees
- Interest and dividends received
- Other operating cash receipts, if any
- Cash paid to employees and other suppliers of goods and services
- Interest paid
- Income taxes paid
- Other operating payments, if any

Firms also are encouraged to provide additional breakdowns beyond the minimum items required under the direct method. For instance, a manufacturer can separate purchases of inventory from selling, general, and administrative expenditures.

5.2 Indirect Method

Firms choosing not to use the direct method then must indirectly calculate net cash from operating activities by removing from net income the effects of these major classes of reconciling items:

- Deferrals of past cash receipts and cash payments (inventory, deferred income, prepaid expenses, and deferred expenses).
- Accruals of expected future cash receipts and payments (accounts receivable and notes receivable from sales transactions; interest receivable; accounts payable and notes payable from transactions with suppliers; interest payable; taxes payable; excess of income under the equity method over dividends; and other accruals).
- Investing or financing-related items and noncash expenses (depreciation; amortization; provision for bad debts; goodwill; gains and losses on the extinguishment of debt; gains and losses on the disposal of property, plant, and equipment; and gains and losses on the disposal of discontinued operations).

This technique is referred to as the *indirect* or *reconciliation* method.

5.3 Reconciliation of Net Cash Flows From Operating Activities to Net Income

A reconciliation of net cash flows from operating activities to net income must be provided, regardless of whether the direct or indirect method is used. The reconciliation separately reports major classes of reconciling items. At a minimum, changes in inventory, payables, and receivables which are related to operating items are separately reported; however, enterprises are encouraged to provide further breakdowns of reconciling items. For instance, changes in receivables from the sale of goods might be reported separately from other receivables.

If the direct method is employed, the reconciliation is to be provided in a separate schedule. If the indirect method is used, the reconciliation may be included in a separate schedule or within the statement of cash flows. Additionally, under the indirect method, both income taxes paid and interest paid, (net of capitalized amounts) must be separately disclosed. In determining net cash from operating activities, all adjustments to net income are to be clearly identified as reconciling items.

5.4 Noncash Transactions

Noncash transactions—for example, nonmonetary exchanges, the conversion of debt to equity, the acquisition of a machine by incurring a liability—are to be reported in related disclosures. These disclosures may be either narrative or summarized within a schedule. The objective of these disclosures is to clearly relate cash and noncash aspects of transactions involving similar items. If a transaction is part cash and part noncash, only the cash portion is reported in the statement of cash flows.

5.5 Exchange Rate Effects

Entities with foreign currency transactions or foreign currency operations must prepare a statement of cash flows reporting the foreign currency equivalent of foreign currency cash flows, using exchange rates in effect at the date of the cash flows. Weighted average exchange rates may be used if the results are not materially different from those rates at the cash flows dates.

The effect of the exchange rate changes on cash balances held in foreign currencies is to be separately reported within the reconciliation of the change in cash and cash equivalents.

5.6 Transition

SFAS 95 is effective for annual statements for fiscal periods ending after July 15, 1988. Enterprises are encouraged, but not required, to restate comparative annual statements. Firms are not required to apply SFAS 95 in interim statements in the year of adoption, but interim cash flow information included with the annual financial statements in the adoption year must be restated.

5.7 Cash Flow Per Share

SFAS 95 specifies that cash flow per share is not to be reported.

5.8 Classification Guidance

Additional guidance on classifying typical investing, financing, and operating activities is provided below.

Investing Activities

Cash outflows for—

- The acquisition of property, plant, and equipment or other productive assets.
- Purchases of debt instruments not designated as cash equivalents or equity instruments.
- Investments in another company.
- Loans made to another entity.

Cash inflows from—

- Proceeds from the disposal of property, plant, and equipment, as well as other productive assets.
- Proceeds from the sale or collection of loans and debt (not cash equivalents).
- The sale or return of investments on equity instruments.
- Collections on loans.

Financing Activities

Cash inflows from—

- Proceeds from the sale or issuance of equity securities.

- Proceeds from the issuance of bonds, mortgages, notes, and other short- or long-term borrowings.

Cash outflows for—

- Payment of dividends to shareholders.
- Other distributions to owners.
- Outlays for repurchase of equity securities.
- Repayment of short- or long-term borrowings.

Operating Activities

Cash inflows from—

- Receipts from the sale of goods or services, or the collection or sale of receivables arising from those sales.
- Interest on investment in debt securities and loans.
- Dividends on investments in equity securities.
- Receipts on other transactions not defined as investing or financing.

Cash outflows for operating activities include—

- Payments for the acquisition of inventory.
- Payments to employees for services.
- Payments for taxes.
- Interest payments, reduced by amounts capitalized.
- Payments to suppliers for other expenses.
- Payments on other transactions not defined as investing or financing.

6. PREPARATION GUIDANCE

Two cases have been prepared. The first examines step-by-step the preparation of each of the parts of the statement of cash flows; the second reviews modifications in reporting guidance in presenting exchange rate effects.

Case 1. Winner Corp.—Preparation of statement of cash flows

The following activities occurred in 19X1 for Winner Corporation, a diversified manufacturing company.

Facts:

- Winner Corp. wrote off $350 of accounts receivable upon the bankruptcy of a customer. A provision of $200 was included in Winner's selling, general, and administrative expenses.
- Winner collected the final installment of $100 on notes receivable for the sale of inventory and collected installment payments of $150 on the sale of a plant. Interest of $55 on these notes was collected through December 31.
- Winner received a dividend of $20 from an affiliate carried under the equity method of accounting.
- Winner sold a facility with a book value of $520, and an original cost of $750, for $600 cash.
- Winner accumulated expenditures of $1,000, which included $10 capitalized interest on a new facility constructed and placed in service for its own use.
- Winner entered into a capital lease for new equipment with a fair value of $850. Principal payments under the lease obligation totaled $125.
- Winner acquired all the capital stock of Poor Mgt. Corp. for $950. The acquisition was recorded under the purchase method. Fair values of assets and liabilities at the date of acquisition are as follows:

Cash	$ 25
Accounts receivable	155
Inventory	350
Property, plant, and equipment	900
Patents	80
Goodwill	70
Accrued expenses and payables	(255)
Long-term notes payable	(375)
	$ 950

- Net borrowings against a line of credit, payable 30 days after demand, totaled $300.
- Winner issued $400 of long-term debt securities.
- The provision for income taxes included a deferred provision of $150.

- Depreciation expenses totaled $430, and the amortization of intangibles totaled $15.
- Winner's selling, general, and administrative expenses included a $50 accrual of incentive compensation, with the related obligation included in other liabilities.
- Winner collected insurance proceeds of $15 from business interruption, attributable to the nondelivery of a shipment of inventory for one week.
- Winner paid $30 to settle a patent infringement.
- Winner issued $1,000 of additional common stock, of which $500 was issued for cash and $500 upon conversion of long-term debt.
- Winner paid $200 in dividends.

Winner's consolidated statement of financial position and consolidated statement of income was as follows:

Winner Corp.
Consolidated Statement of Financial Position

	01/01/X1	*12/31/X1*	*Change*
Assets:			
Cash and cash equivalents	$ 600	$ 1,665	$ 1,065
Accounts receivable (net of allowance for losses of $600 and $450)	1,770	1,940	170
Notes receivable	400	150	(250)
Inventory	1,230	1,375	145
Prepaid expenses	110	135	25
Investments	250	275	25
Property, plant, and equipment, at cost	6,460	8,460	2,000
Accumulated depreciation	(2,100)	(2,300)	(200)
Property, plant, and equipment, net	4,360	6,160	1,800
Intangible assets	40	175	135
Total assets	$ 8,760	$ 11,875	$ 3,115

Winner Corp.
Consolidated Statement of Financial Position

	01/01/X1	*12/31/X1*	*Change*
Liabilities:			
Accounts payable and accrued expenses	$ 1,085	$ 1,090	$ 5
Interest payable	30	45	15
Income taxes payable	50	85	35
Short-term debt	450	750	300
Lease obligation	—	725	725
Long-term debt	2,150	2,425	275
Deferred taxes	375	525	150
Other liabilities	225	275	50
Total liabilities	4,365	5,920	1,555
Stockholders' Equity:			
Capital stock	2,000	3,000	1,000
Retained earnings	2,395	2,955	560
Total stockholders' equity	4,395	5,955	1,560
Total liabilities and stockholders' equity	$ 8,760	$ 11,875	3,115

Winner Corp.
Consolidated Statement of Income
for the Year Ended December 31, 19X1

Sales	$ 13,965
Cost of sales	(10,290)
Depreciation and amortization	(445)
Selling, general, and administrative expenses	(1,890)
Interest expense	(235)
Equity in earnings of affiliate	45
Gain on sale of facility	80
Interest income	55
Insurance proceeds	15
Loss from patent infringement lawsuit	(30)
Income before income taxes	1,270
Provision for income taxes	(510)
Net income	$ 760

Cash flow from operating activities under the direct method is presented in Exhibit 2-1A.

SFAS 95 requires that the following be presented separately: cash collected from customers, interest, and dividends receipts; cash paid to suppliers and employees; interest paid; and income taxes paid. Other operating receipts include insurance proceeds. Other cash payments include settlement of lawsuit.

Exhibit 2-1A *Winner Corp.*
Cash Flows From Operating Activities (Direct Approach)

Cash Flows From Operating Activities:	
Cash received from customers	$13,850 (A)
Cash paid to suppliers and employees	(12,000) (B)
Dividends received from affiliate	20
Interest received	55
Interest paid (net of capitalized amount)	(220)
Income taxes paid	(325)
Insurance proceeds received	15
Cash paid to settle lawsuit	(30)
Net cash provided by operating activities	$ 1,365

Derivations of cash received from customers, as well as cash paid to suppliers and employees, are as follows:

Cash Received From Customers During the Year: (A)		
Customer sales		$ 13,965
Collection of installment payment for sale of inventory		100
Gross accounts receivable at beginning of year	$ 2,370	
Accounts receivable acquired in purchase of Company 5	155	
Accounts receivable written off	(350)	
Gross accounts receivable at end of year	(2,390)	
Excess of new accounts receivable over collections from customers		(215)
Cash received from customers during the year		$ 13,850

Exhibit 2-1A (cont.)

Cash Paid to Suppliers and Employees During the Year: (B)			
Cost of sales			$ 10,290
General and administrative expenses		1,890	
Expenses not requiring cash outlay (provision for uncollectible accounts receivable)		(200)	
Net expenses requiring cash payments			1,690
Inventory at beginning of year		(1,230)	
Inventory acquired in purchase of Company S		(350)	
Inventory at end of year		1,375	
Net decrease in inventory from company M's operations			(205)
Adjustments for Changes in Related Accruals:			
Account balances at beginning of year			
Accounts payable and accrued expenses	$ 1,085		
Other liabilities	225		
Prepaid expenses	(110)		
Total		1,300	
Accounts payable and accrued expenses acquired in purchase of Company S		255	
Account balances at end of year			
Accounts payable and accrued expenses	1,090		
Other liabilities	275		
Prepaid expenses	(135)		
Total		(1,230)	
Additional cash payments not included in expense			225
Cash paid to suppliers and employees during the year			$ 12,000

Exhibit 2-1B presents cash flows from operating activities under the indirect method. As required under SFAS 95, the indirect approach reconciles cash flows from operating activities with net income. Changes in receivables, payables, and inventory are separately reported in the reconciliation. Accruals of future receipts and deferrals of past receipts include receipts on note for the sale of inventory and undistributed earnings of the subsidiary. Noncash expenses consisting of depreciation and amortization, deferred income taxes, and bad debt provisions on receivables are added back. Financing and investment-related items include the gain on the sale of the facility and the acquisition of Poor Mgt. Corp. The adjustments are clearly labeled as such.

Exhibit 2-1B *Winner Corp.*
Cash Flows From Operating Activities (Indirect Approach)

Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Receipt on note for sale of inventory	100	
Change in assets and liabilities net effects from purchase of Poor Mgt. Corp.:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expense	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	605
Net cash provided by operating activities		$1,365

The determination of activities and amounts that will be designated as investing activities is shown in Exhibit 2-1C.

In accordance with the requirements of SFAS 95, the proceeds from the sale of the facility and plant are shown separately from capital expenditures. The sale is at a gross amount, including an $80 gain.

Exhibit 2-1C *Winner Corp.*
Cash Flows From Investing Activities

Proceeds from sale of facility	$ 600
Payment on note for sale of plant	150
Capital expenditures	(1,000)
Payment for purchase of Poor Mgt. Corp., net of cash received	(925)
Net cash used in investing	$(1,175)

The activities and the amounts of financing activities are as presented in Exhibit 2-1D.

Following SFAS 95, gross proceeds and payments on borrowings are presented separately. Only the principal payments for leases appear under cash flows from investing activities; entering into the lease is disclosed in a supplemental note. Dividends paid are financing-related, while interest both paid and received is classified as operating activities.

Exhibit 2-1D *Winner Corp.*
Cash Flows From Financing Activities

Net borrowing from line of credit	$ 300
Principal payments under capital lease	(125)
Proceeds from issuance of long-term debt	400
Proceeds from issuance of capital stock	500
Dividends paid	(200)
Net cash provided by financing activities	$ 875

The supplemental schedule for noncash activities and any additional disclosures are shown in Exhibit 2-1E.

Under SFAS 95, the notes using the direct approach would include the reconciliation of net income to net cash provided by operations. This could be omitted under the indirect approach; then, disclosures of cash paid for interest net of amounts capitalized and amounts paid for income taxes would be separately disclosed.

Exhibit 2-1E *Winner Corp.*

Reconciliation of Net Income to Net Cash Provided by Operating Activities:		
Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	

Exhibit 2-1E (cont.)

Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		$1,365

Supplemental Schedule of Noncash Investing and Financing Activities:
Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$ 1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of Accounting Policy:
For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Appendix A provides samples of the statement of cash flows using both the direct and indirect methods for Winner Corp. Appendices B and C illustrate the application of SFAS 95 to a consolidated statement for a multinational company and a financial institution, respectively.

Case 2. Inactive Overseas Company—modifications in reporting guidance

Inactive Overseas Company, a foreign subsidiary whose functional currency is the foreign currency (FC), had little activity in 19X7. In fact, the only event occurring was the sale of land on 6/30/X7 for $20, which was at the book value.

Other information:

Cash 1/1/X7:	(FC) 100
Cash 12/31/X7:	(FC) 120

Exchange rates from FC to U.S. dollars were .12 at 1/1/X7, .13 at 6/30/X7, and .15 at 12/31/X7.

When preparing the statement of cash flows the dollar amount used in reporting sale of land and exchange rate gain or loss is as follows.

Exhibit 2-2A *Dollar Amount for Reporting Sale of Land*

Under SFAS 95, companies would report as follows:

	Foreign Currency	*Exchange Rate*	*Translated Amount (Amount Reported)*
Investing Activities:			
Cash from sale of land	20 FC	.13	$2.60
Exchange gain			$3.40

Exhibit 2-2B *Exchange Rate Gain or Loss*

Prior to SFAS 95, SFAS 52, *Foreign Currency Translation,* provided no guidance for the preparation of the statement of changes in financial position. One solution that had been used in practice is as follows:

	Foreign Currency	*Exchange Rate*	*Translated Amount (Amount Reported)*
Investing Activities:			
Cash from sale of land	20 FC	.15	$3.00
Exchange gain			$3.00

The $3.00 exchange gain presented under past practice was calculated by holding $100 over the entire year ($100) (.15-.12). SFAS 95 translates cash inflows and outflows using the exchange rate at the date of the transaction: 20FC (.13). Accordingly, the exchange gain is calculated as the sum of the exchange gain from holding 100 FC for the year and 20 FC for half a year: 100FC (.15-.12) + 20FC (.15-.13). The exchange gain must be identified separately in the statement of cash flows.

APPENDIX A

Presenting Winner Corp. Statement of Cash Flows

DIRECT METHOD

Winner Corp.
Consolidated Statement of Cash Flows
for the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents: Direct Method

Cash Flows From Operating Activities:		
Cash received from customers	$ 13,850	
Cash paid to suppliers and employees	(12,000)	
Dividend received from affiliate	20	
Interest received	55	
Interest paid (net of amount capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received	15	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		$ 1,365
Cash Flows From Investing Activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Poor Mgt. Corp., net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash Flows From Financing Activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		$ 1,665

Reconciliation of Net Income to Net Cash Provided by Operating Activities:

Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		$ 1,365

Supplemental Schedule of Noncash Investing and Financing Activities:
Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$ 1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of Accounting Policy:
For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

INDIRECT METHOD

Winner Corp.
Consolidated Statement of Cash Flows
for the Year Ended December 31, 19X1
Increase/Decrease in Cash and Cash Equivalents: Indirect Method

Cash Flows From Operating Activities:		
Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		1,365
Cash Flows From Investing Activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Poor Mgt. Corp., net of cash acquired	(925)	
Net cash used in investing activities		(1,175)

Cash Flows From Financing Activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		$ 1,665

Supplemental Disclosures of Cash Flow Information:
Cash paid during the year for:

Interest (net of amount capitalized)	$ 220
Income taxes	325

Supplemental Schedule of Noncash Investing and Financing Activities:
Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$ 1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of Accounting Policy:
For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

APPENDIX B

Statement of Cash Flows for a Manufacturing Company with Foreign Operations

136. Presented below is a consolidating statement of cash flow for the year ended December 31, 19X1 for Company F, a multinational U.S. corporation engaged principally in manufacturing activities, which has two wholly owned foreign subsidiaries—Subsidiary A and Subsidiary B. For Subsidiary A, the local currency is the functional currency. For Subsidiary B, which operated in a highly inflationary economy, the U.S. dollar is the functional currency.

Company F
Consolidating Statement of Cash Flows
for the Year Ended December 31, 19X1
Increase/Decrease in Cash and Cash Equivalents

	Parent Company	*Subsidiary A*	*Subsidiary B*	*Eliminations*	*Consolidated*
Cash Flows From Operating Activities:					
Cash received from customers	$ 4,610[a]	$ 888[a]	$ 561[a]	$(430)	$ 5,629
Cash paid to suppliers and employees	(3,756)[a]	(806)[a]	(370)[a]	430	(4,502)
Interest paid	(170)	(86)	(135)	—	(391)
Income taxes paid	(158)	(25)	(21)	—	(204)
Interest and dividends received	(57)	—	—	(22)	35
Miscellaneous cash received (paid)	—	45	(5)	—	40
Net cash provided by operating activities	583	16	30	(22)	607

	Parent Company	*Subsidiary A*	*Subsidiary B*	*Eliminations*	*Consolidated*
Cash Flows From Investing Activities:					
Proceeds from sale of equipment	150	116	14	—	280
Payments for purchase of equipment	(450)	(258)	(15)	—	280
Net cash used in investing activities	(300)	(142)	(1)	—	(443)
Cash Flows From Financing Activities:					
Proceeds from issuance of short-term debt	20	75	—	—	95
Intercompany loan	(15)	—	15	—	—
Proceeds from issuance of long-term debt	—	165	—	—	165
Repayment of long-term debt	(200)	(105)	(35)	—	(340)
Payment of dividends	(120)	(22)	—	22	(120)
Net cash provided by (used in) financing activities	(315)	113	(20)	22	(200)
Effect of exchange rate changes on cash	—	9[b]	(5)[b]	—	4
Net change in cash and cash equivalents	(32)	(4)	4	—	(32)
Cash and cash equivalents at beginning of year	255	15	5	—	275
Cash and cash equivalents at end of year	$ 223	$ 11	$ 9	$ —	$ 243

	Parent Company	Subsidiary A	Subsidiary B	Eliminations	Consolidated
Reconciliation of Net Income to Net Cash Provided by Operating Activities:					
Net income	$ 417	$ 50	$ (66)	$(37)	$ 364
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	350	85	90	—	525
(Gain) loss on sale of equipment	(115)	—	25	—	(90)
Writedown of facility to net realizable value	50	—	—	—	50
Exchange gain	—	—	(115)	—	(115)
Provision for deferred taxes	90	—	—	—	90
Increase in accounts receivable	(85)	(37)		—	(131)
(Increase) decrease in inventory	(80)	(97)	107	15	(55)
Increase (decrease) in accounts payable and accrued expenses	(41)	16	(6)	—	(31)
Increase (decrease) in interest and taxes payable	(3)	(1)	4	—	—
Net cash provided by operating activities	$ 583	$ 16	$ 30	$(22)	$ 607

Disclosure of Accounting Policy:
Cash in excess of daily requirements is invested in marketable securities consisting of Treasury bills with maturities of three months or less. Such investments are deemed to be cash equivalents for purposes of the statement of cash flows.

[a]The computation of this amount is provided in paragraph 145.

[b]The computation of this amount is provided in paragraph 146.

137. Summarized below is financial information for the current year for Company F, which provides the basis for the statement of cash flows presented in paragraph 136:

Company F
Consolidating Statement of Financial Position
December 31, 19X1

	Parent Company	*Subsidiary A*	*Subsidiary B*	*Eliminations*	*Consolidated*
Assets:					
Cash and cash equivalents	$ 223	$ 11	$ 9	$ —	$ 243
Accounts receivable	725	95	20	—	840
Intercompany loan receivable	15	—	—	(15)	—
Inventory	630	281	96	(15)	992
Investments	730	—	—	(730)	—
Property, plant, and equipment, net	3,305	1,441	816	—	5,562
Other assets	160	11	—	—	171
Total assets	$5,788	$1,839	$941	$(760)	$7,808
Liabilities:					
Accounts payable and accrued expenses	$ 529	$ 135	$ 38	$ —	$ 702
Interest payable	35	11	4	—	50
Taxes payable	45	5	2	—	52
Short-term debt	160	135	—	—	295
Intercompany debt	—	—	15	(15)	—
Long-term debt	1,100	315	40	—	1,455
Deferred taxes	342	—	—	—	342
Total liabilities	2,211	601	99	(15)	2,896
Stockholders' Equity:					
Capital stock	550	455	275	(730)	550
Retained earnings	3,027	554	567	(15)	4,133
Cumulative translation adjustment	—	229	—	—	229
Total stockholders' equity	3,577	1,238	842	(745)	4,912
Total liabilities and stockholders' equity	$5,788	$1,839	$941	$(760)	$7,808

Company F
Consolidating Statement of Income
for the Year Ended December 31, 19X1

	Parent Company	*Subsidiary A*	*Subsidiary B*	*Eliminations*	*Consolidated*
Revenues	$4,695	$ 925	$ 570	$(430)	$ 5,760
Cost of sales	(3,210)	(615)	(406)	415	(3,816)
Depreciation and amortization	(350)	(85)	(90)	—	(525)
General and administrative expenses	(425)	(110)	(65)	—	(600)
Interest expense	(165)	(90)	(135)	—	(390)
Interest and dividend income	57	—	—	(22)	35
Gain (loss) on sale of equipment	115	—	(25)	—	90
Miscellaneous income (expense)	(50)	45	(5)	—	(10)
Exchange gain	—	—	115	—	115
Income before income taxes	667	70	(41)	(37)	659
Provision for income taxes	(250)	(20)	(25)	—	(295)
Net income	$ 417	$ 50	$ (66)	$ (37)	$ 364

138. The U.S. dollar equivalents of one unit of local currency [LC] applicable to Subsidiary A and to Subsidiary B are as follows:

	Subsidiary A	*Subsidiary B*
1/1/X1	.40	.05
Weighted average	.43	.03
12/31/X1	.45	.02

The computation of the weighted-average exchange rate for Subsidiary A excludes the effect of Subsidiary A's sale of inventory to the parent company at the beginning of the year discussed in paragraph 142(a).

139. Comparative statements of financial position for the parent company and for each of the foreign subsidiaries are presented below:

Comparative Statements of Financial Position

	Parent Company			Subsidiary A Local Currency		
	1/1/X1	12/31/X1	Change	1/1/X1	12/31/X1	Change
Assets:						
Cash and cash equivalents	$ 255	$ 223	$ (32)	LC 38	LC 25	LC (13)
Accounts receivable	640	725	85	125	210	85
Intercompany loan receivable	—	15	15	—	—	—
Inventory	550	630	80	400	625	225
Investments	730	730	—	—	—	—
Property, plant, and equipment, net	3,280	3,305	25	3,075	3,202	127
Other assets	170	160	(10)	25	25	—
Total assets	$5,625	$5,788	$ 163	LC3,663	LC4,087	LC424
Liabilities:						
Accounts payable and accrued expenses	$ 570	$ 529	$ (41)	LC 263	LC 300	LC 37
Interest payable	40	35	(5)	15	24	9
Taxes payable	43	45	2	25	12	(13)
Short-term debt	140	160	20	125	300	175
Intercompany debt	—	—	—	—	—	—
Long-term debt	1,300	1,100	(200)	550	700	150
Deferred taxes	252	342	90	—	—	—
Total liabilities	2,345	2,211	(134)	978	1,336	358
Stockholders' Equity:						
Capital stock	550	550	—	1,300	1,300	—
Retained earnings	2,730	3,027	297	1,385	1,451	66
Cumulative translation adjustment	—	—	—	—	—	—
Total stockholders' equity	3,280	3,577	297	2,685	2,751	66
Total liabilities and stockholders' equity	$5,625	$5,788	$163	LC3,663	LC4,087	LC424

Subsidiary A			Subsidiary B			Subsidiary B		
U.S. Dollars			Local Currency			U.S. Dollars		
1/1/X1	12/31/X1	Change	1/1/X1	12/31/X1	Change	1/1/X1	12/31/X1	Change
$ 15	$ 11	$ (4)	LC 100	LC 449	LC 349	$ 5	$ 9	$ 4
50	95	45	700	1,000	300	35	20	(15)
—	—	—	—	—	—	—	—	—
160	281	121	2,900	3,200	300	203	96	(107)
—	—	—	—	—	—	—	—	—
1,230	1,441	211	6,200	5,900	(300)	930	816	(114)
10	11	1	—	—	—	—	—	—
$1,465	$1,839	$374	LC9,900	LC10,549	LC 649	$1,173	$941	$(232)
$ 105	$ 135	$ 30	LC2,100	LC 1,900	LC (200)	$ 105	$ 38	$ (67)
6	11	5	200	200	—	10	4	(6)
10	5	(5)	—	120	120	—	2	2
50	135	85	—	—	—	—	—	—
—	—	—	—	500	500	—	15	15
220	315	95	3,000	2,000	(1,000)	150	40	(110)
—	—	—	—	—	—	—	—	—
391	601	210	5,300	4,720	(580)	265	99	(166)
455	455	—	1,375	1,375	—	275	275	—
526	554	28	3,225	4,454	1,229	633	567	(66)
93	229	136	—	—	—	—	—	—
1,074	1,238	164	4,600	5,829	1,229	908	842	(66)
$1,465	$1,839	$374	LC9,900	LC10,549	LC 649	$1,173	$941	$(232)

140. Statements of income in local currency and U.S. dollars for each of the foreign subsidiaries are presented below:

Statements of Income
for the Year Ended December 31, 19X1

	Subsidiary A		*Subsidiary B*	
	Local Currency	*U.S. Dollars*	*Local Currency*	*Dollars*
Revenues	LC2,179	$925[a]	LC19,000	$570
Cost of sales	(1,458)	(615)[b]	(9,667)	(406)
Depreciation and amortization	(198)	(85)	(600)	(90)
General and administrative expenses	(256)	(110)	(2,167)	(65)
Interest expense	(209)	(90)	(4,500)	(135)
Gain (loss) on sale of equipment	—	—	150	(25)
Miscellaneous income (expense)	105	45	(167)	(5)
Exchange gain	—	—	—	115
Income before income taxes	163	70	2,049	(41)
Provision for income taxes	(47)	(20)	(820)	(25)
Net income	LC116	$ 50	LC 1,229	$ (66)

[a]This amount was computed as follows:

Sale to parent company at beginning of year	LC 400 @ .40 =	$160
Sales to customers	LC1,779 @ .43 =	765
Total sales in U.S. dollars		$925

[b]This amount was computed as follows:

Cost of sale to parent company at beginning of year	LC 400 @ .40 =	$160
Cost of sales to customers	LC1,058 @ .43 =	455
Total cost of sales in U.S. dollars		$615

141. The following transactions were entered into during the year by the parent company and are reflected in the above financial statements:

a. The parent company invested cash in excess of daily requirements in Treasury bills. Interest earned on such investments totaled $35.
b. The parent company sold excess property with a net book value of $35 for $150.
c. The parent company's capital expenditures totaled $450.

d. The parent company wrote down to its estimated net realizable value of $25 a facility with a net book value of $75.
e. The parent company's short-term debt consisted of commercial paper with maturities not exceeding 60 days.
f. The parent company repaid long-term notes of $200.
g. The parent company's depreciation totaled $340, and amortization of intangible assets totaled $10.
h. The parent company's provision for income taxes included deferred taxes of $90.
i. Because of a change in product design, the parent company purchased all of Subsidiary A's beginning inventory for its book value of $160. All of the inventory was subsequently sold by the parent company.
j. The parent company received a dividend of $22 from Subsidiary A. The dividend was credited to the parent company's income.
k. The parent company purchased from Subsidiary B $270 of merchandise of which $45 remained in the parent company's inventory at year-end. Intercompany profit on the remaining inventory totaled $15.
l. The parent company loaned $15, payable in U.S. dollars, to Subsidiary B.
m. Company F paid dividends totaling $120 to shareholders.

142. The following transactions were entered into during the year by Subsidiary A and are reflected in the above financial statements. The U.S. dollar equivalent of the local currency amount based on the exchange rate at the date of each transaction is included. Except for the sale of inventory to the parent company (transaction (a) below), Subsidiary A's sales and purchases and operating cash receipts and payments occurred evenly throughout the year.

a. Because of a change in product design, Subsidiary A sold all of its beginning inventory to the parent company for its book value of LC400 ($160).
b. Subsidiary A sold equipment for its book value of LC275 ($116) and purchased new equipment at a cost of LC600 ($258).
c. Subsidiary A issued an additional LC175 ($75) of 30-day notes and renewed the notes at each maturity date.
d. Subsidiary A issued long-term debt of LC400 ($165) and repaid long-term debt of LC250 ($105).
e. Subsidiary A paid a dividend to the parent company of LC50 ($22).

143. The following transactions were entered into during the year by Subsidiary B and are reflected in the above financial statements. The U.S. dollar equivalent of the local currency [LC] amount based on the exchange rate at the date of each transaction is included. Subsidiary B's sales and operating cash receipts and paymentss occurred evenly throughout the year. For convenience, all purchases of inventory were based on the weighted-average exchange rate for the year. Subsidiary B uses the FIFO method of inventory valuation.

Subsidiary B had sales to the parent company as follows:

	Local Currency	*U.S. Dollars*
Intercompany sales	LC 9,000	$ 270
Cost of sales	(4,500)	(180)
Gross profit	LC 4,500	$ 90

Subsidiary B sold equipment with a net book value of LC200 ($39) for LC350 ($14). New equipment was purchased at a cost of LC500 ($15).

Subsidiary B borrowed $15 (LC500), payable in U.S. dollars, from the parent company.

Subsidiary B repaid LC1,000 ($35) of long-term debt.

144. Statements of cash flows in the local currency and in U.S. dollars for Subsidiary A and Subsidiary B are presented below:

Statements of Cash Flows
for the Year Ended December 31, 19X1
Increase (Decrease) in Cash

	Subsidiary A		*Subsidiary B*	
	Local Currency	*U.S. Dollars*	*Local Currency*	*U.S. Dollars*
Cash Flows From Operating Activities:				
Cash received from customers	LC 2,094[a]	$ 888[a]	LC 18,700[a]	$ 561[a]
Cash paid to suppliers and employees	(1,902)[a]	(806)[a]	(12,334)[a]	(370)[a]
Interest paid	(200)	(86)[b]	(4,500)	(135)[b]
Income taxes paid	(60)	(25)[b]	(700)	(21)[b]
Miscellaneous receipts (payments)	105	45[b]	(167)	(5)[b]
Net cash provided by operating activities	37	16	999	30

	Subsidiary A		Subsidiary B	
	Local Currency	U.S. Dollars	Local Currency	U.S. Dollars
Cash Flows From Investing Activities:				
Proceeds from sale of equipment	275	116[c]	350	14[c]
Payments for purchase of equipment	(600)	(258)[c]	(500)	(15)[c]
Net cash used in investing activities	(325)	(142)	(150)	(1)
Cash Flows From Financing Activities:				
Net increase in short-term debt	175	75[c]	—	—
Proceeds from inter-company loan	—	—	500	15[c]
Proceeds from issuance of long-term debt	400	165[c]	—	—
Repayment of long-term debt	(250)	(105)[c]	(1,000)	(35)[c]
Payment of dividends	(50)	(22)[c]	—	—
Net cash provided by (used in) financing activities	275	113	(500)	(20)
Effect of exchange rate changes on cash	—	9[d]	—	(5)[d]
Net increase (decrease) in cash	(13)	(4)	349	4
Cash at beginning of year	38	15	100	5
Cash at end of year	LC 25	$ 11	LC 449	$ 9

[a]The computation of this amount is provided in paragraph 145.

[b]This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the weighted-average exchange rate for the year.

[c]This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on exchange rate in effect at the time of the cash flow.

[d]The computation of this amount is provided in paragraph 146.

	Subsidiary A		Subsidiary B	
	Local Currency	U.S. Dollars	Local Currency	U.S. Dollars
Reconciliation of Net Income to Net Cash Provided by Operating Activities:				
Net income	LC 116	$ 50	LC 1,229	$(66)
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	198	85[a]	600	90[b]
(Gain) loss on sale of equipment	—	—	(150)	25[b]
Exchange gain	—	—	—	(115)[c]
Increase in accounts receivable	(85)	(37)[a]	(300)	(9)[a]
(Increase) decrease in inventory	(225)	(97)[a]	(300)	(107)[d]
Increase (decrease) in accounts payable and accrued expenses	37	16[a]	(200)	(6)[a]
Increase (decrease) in interest and taxes payable	(4)	(1)[a]	120	4[a]
Net cash provided by operating activities	LC 37	$ 16	LC 999	$ 30

[a]This amount represents the U.S. dollar equivalent of the foreign currency amount based on the weighted-average exchange rate for the year.

[b]This amount represents the U.S. dollar equivalent of the foreign currency amount based on historical exchange rates.

[c]This amount represents the exchange gain included in net income as a result of remeasuring Subsidiary B's financial statements from the local currency to U.S. dollars.

[d]This amount represents the difference between beginning and ending inventory after remeasurement into U.S. dollars based on historical exchange rates.

145. Presented below is the computation of cash received from customers and cash paid to suppliers and employees as reported in the consolidating statement of cash flows for Company F appearing in paragraph 136:

		Subsidiary A		*Subsidiary B*	
	Parent Company	*Local Currency*	*U.S. Dollars*	*Local Currency*	*U.S. Dollars*
Cash Received From Customers During the Year:					
Revenues	$4,695	LC2,179	$925	LC19,000	$570
Increase in accounts receivable	(85)	(85)	(37)	(300)	(9)
Cash received from customers	$4,610	LC2,094	$888	LC18,700	$561
Cash Paid to Suppliers and Employees During the Year:					
Cost of Sales	$3,210	LC1,458	$615	LC 9,667	$406
Effect of exchange rate changes on cost of sales	—	—	—	—	(116)[a]
General and administrative expenses	425	256	110	2,167	65
Total operating expenses requiring cash payments	3,635	1,714	725	11,834	355
Increase in inventory	80	225	97	300	9
(Increase) decrease in accounts payable and accrued expenses	41	(37)	(16)	200	6
Cash paid to suppliers and employees	$3,756	LC1,902	$806	LC12,334	$370

[a]This adjustment represents the difference between cost of sales remeasured at historical exchange rates ($406) and cost of sales translated based on the weighted-average exchange rate for the year ($290). This adjustment is necessary because cash payments for inventory, which were made evenly throughout the year, were based on the weighted-average exchange rate for the year.

146. Presented below is the computation of the effect of exchange rate changes on cash for Subsidiary A and Subsidiary B:

Computation of Effect of Exchange Rate Changes on Cash

	Subsidiary A		*Subsidiary B*	
Effect on Beginning Cash Balance:				
Beginning cash balance in local currency	LC 38		LC 100	
Net change in exchange rate during the year	× .05		× (.03)	
Effect on beginning cash balance		$ 2		$ (3)
Effect from Operating Activities During the Year:				
Cash provided by operating activities in local currency	LC 37		LC 999	
Year-end exchange rate	× .45		× .02	
Operating cash flows based on year-end exchange rate	$ 16[a]		$ 20	
Operating cash flows reported in the statement of cash flows	16		30	
Effect from operating activities during the year		0		(10)
Effect from Investing Activities During the Year:				
Cash used in investing activities in local currency	LC(325)		LC(150)	
Year-end exchange rate	× .45		× .02	
Investing cash flows based on year-end exchange rate	$(146)		$ (3)	
Investing cash flows reported in the statement of cash flows	(142)		(1)	
Effect from investing activities during the year		(4)		(2)
Effect from Financing Activities During the Year:				
Cash provided by (used in) financing activities in local currency	LC 275		LC(500)	
Year-end exchange rate	× .45		× .02	
Financing cash flows based on year-end exchange rate	$ 124[a]		$(10)	
Financing cash flows reported in the statement of cash flows	113		(20)	
Effect from financing activities during the year		11		10
Effect of exchange rate changes on cash		$ 9		$ (5)

[a]This amount includes the effect of rounding.

APPENDIX C

Statement of Cash Flows Under the Direct Method for a Financial Institution

147. Presented below is a statement of cash flows for Financial Institution, Inc., a U.S. corporation that provides a broad range of financial services. This statement of cash flows illustrates the direct method of presenting cash flows from operating activities, as encouraged in paragraph 27 of this Statement [SFAS 95]. An exposure draft on SFAS 95 with a comment period ending December 29, 1988, would require that cash receipts and payments resulting (a) from purchases and sales of debt or equity securities that are carried at market value in a trading account and are held principally for resale to customers and (b) from originations on purchases and sales of certain loans that are acquired specifically for resale be classified as operating activities in a statement of cash flows. Accordingly the presentations of trading securities as investing activities would change under this proposal.

Financial Institution, Inc.
Statement of Cash Flows
for the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash Flows From Operating Activities:		
Interest received	$ 5,350	
Fees and commissions received	1,320	
Financing revenue received under leases	60	
Interest paid	(3,925)	
Cash paid to suppliers and employees	(795)	
Income taxes paid	(471)	
Net cash provided by operating activities		$ 1,539
Cash Flows From Investing Activities:		
Proceeds from sales of trading and investment securities	22,700	
Purchase of trading and investment securities	(25,000)	
Net increase in credit card receivables	(1,300)	
Net decrease in customer loans with maturities of 3 months or less	2,250	
Principal collected on longer term loans	26,550	
Longer term loans made to customers	(36,300)	
Purchase of assets to be leased	(1,500)	
Principal payments received under leases	107	
Capital expenditures	(450)	

Proceeds from sale of property, plant, and equipment	260	
Net cash used in investing activities		(12,683)
Cash Flows From Financing Activities:		
Net increase in demand deposits, NOW accounts and savings accounts	3,000	
Proceeds from sales of certificates of deposit	63,000	
Payments for maturing certificates of deposit	(61,000)	
Net increase in federal funds purchased	4,500	
Net increase in 90-day borrowings	50	
Proceeds from issuance of nonrecourse debt	600	
Principal payment on nonrecourse debt	(20)	
Proceeds from issuance of 6-month note	100	
Proceeds from issuance of long-term debt	1,000	
Repayment of long-term debt	(200)	
Proceeds from issuance of common stock	350	
Payments to acquire treasury stock	(175)	
Dividends paid	(240)	
Net cash provided by financing activities		10,965
Net decrease in cash and cash equivalents		(179)
Cash and cash equivalents at beginning of year		6,700
Cash and cash equivalents at end of year		$ 6,521
Reconciliation of Net Income to Net Cash Provided by Operating Activities:		
Net income		$ 1,056
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	$ 100	
Provision for probable credit losses	300	
Provision for deferred taxes	58	
Gain on sale of trading and investment securities	(100)	
Gain on sale of equipment	(50)	
Increase in taxes payable	175	
Increase in interest receivable	(150)	
Increase in interest payable	75	
Decrease in fees and commissions receivable	20	
Increase in accrued expenses	55	
Total adjustments		483
Net cash provided by operating activities		$ 1,539
Supplemental Schedule of Noncash Investing and Financing Activities:		
Conversion of long-term debt to common stock		$ 500

Disclosure of Accounting Policy:
For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally federal funds are purchased and sold for one-day periods.

148. Summarized below is financial information for the current year for Financial Institution, Inc., which provides the basis for the statement of cash flows presented in paragraph 147:

Financial Institution, Inc.
Statement of Financial Position

	1/1/X1	*12/31/X1*	*Change*
Assets:			
Cash and due from banks	$ 4,400	$ 3,121	$ (1,279)
Federal funds sold	2,300	3,400	1,100
Total cash and cash equivalents	6,700	6,521	(179)
Investment and trading securities	9,000	11,400	2,400
Credit card receivables	8,500	9,800	1,300
Loans	28,000	35,250	7,250
Allowance for credit losses	(800)	(850)	(50)
Interest receivable	600	750	150
Fees and commissions receivable	60	40	(20)
Investment in direct financing lease	—	421	421
Investment in leveraged lease	—	392	392
Property, plant, and equipment, net	525	665	140
Total assets	$52,585	$64,389	$11,804
Liabilities:			
Deposits	$38,000	$43,000	$ 5,000
Federal funds purchased	7,500	12,000	4,500
Short-term borrowings	1,200	1,350	150
Interest payable	350	425	75
Accrued expenses	275	330	55
Taxes payable	75	250	175
Dividends payable	0	80	80
Long-term debt	2,000	2,300	300
Deferred taxes	—	58	58
Total liabilities	49,400	59,793	10,393

	1/1/X1	12/31/X1	Change
Stockholders' Equity:			
Common stock	1,250	2,100	850
Treasury stock	0	(175)	(175)
Retained earnings	1,935	2,671	736
Total stockholders' equity	3,185	4,596	1,411
Total liabilities and stockholders' equity	$52,585	$64,389	$11,804

Financial Institution, Inc.
Statement of Income
for the Year Ended December 31, 19X1

Revenues:		
Interest income	$5,500	
Fees and commissions	1,300	
Gain on sale of investment securities	100	
Lease income	60	
Gain on sale of equipment	50	
Total revenues		$7,010
Expenses:		
Interest expense	4,000	
Provision for probable credit losses	300	
Operating expenses	850	
Depreciation	100	
Total expenses		5,250
Income before income taxes		1,760
Provision for income taxes		704
Net income		$1,056

149. The following transactions were entered into by Financial Institution, Inc., during 19X1 and are reflected in the above financial statements.

a. Financial Institution sold trading and investment securities with a book value of $22,600 for $22,700 and purchased $25,000 in new trading and investment securities.

b. Financial Institution had a net decrease in short-term loans receivable (those with original maturities of 3 months or less) of $2,250. Financial Institution made longer term loans of $36,300 and collected $26,550 on those loans. Financial Institution wrote off $250 of loans as uncollectible.

c. Financial Institution purchased property for $500 to be leased under a direct financing lease. The first annual rental payment of $131 was collected. The portion of the rental payment representing interest income totaled $52.

d. Financial Institution purchased equipment for $1,000 to be leased under a leveraged lease. The cost of the leased asset was financed by an equity investment of $400 and a long-term nonrecourse bank loan of $600. The first annual rental payment of $90, of which $28 represented principal, was collected, and the first annual loan installment of $74, of which $20 represented principal, was paid. Pretax income of $8 was recorded.

e. Financial Institution purchased new property, plant, and equipment for $450 and sold property, plant, and equipment with a book value of $210 for $260.

f. Customer deposits with Financial Institution consisted of the following:

	1/1/X1	*12/31/X1*	*Increase*
Demand deposits	$ 8,000	$ 8,600	$ 600
NOW accounts and savings accounts	15,200	17,600	2,400
Certificates of deposit	14,800	16,800	2,000
Total deposits	$38,000	$43,000	$5,000

Sales of certificates of deposit during the year totaled $63,000; certificates of deposit with principal amounts totaling $61,000 matured. For presentation in the statement of cash flows, Financial Institution chose to report gross cash receipts and payments for both certificates of deposit with maturities of three months or less and those with maturities of more than three months.

g. Short-term borrowing activity for Financial Institution consisted of repayment of a $200 90-day note and issuance of a 90-day note for $250 and a 6-month note for $100.

h. Financial Institution repaid $200 of long-term debt and issued 5-year notes for $600 and 10-year notes for $400.

i. Financial Institution issued $850 of common stock, $500 of which was issued upon conversion of long-term debt and $350 of which was issued for cash.

j. Financial Institution acquired $175 of treasury stock.

k. Financial Institution declared dividends of $320. The fourth quarter dividend of $80 was payable the following January.

l. Financial Institution's provision for income taxes included a deferred provision of $58.

m. In accordance with paragraph 7, footnote 1, of this Statement [SFAS 95], interest paid includes amounts credited directly to demand deposit, NOW, and savings accounts.

APPENDIX D

Financial Statements and Notes Checklist for Cash Flows

Following are selected questions pertinent to Statement of Financial Accounting Standards No. 95. These items are extracted from AICPA *Auditing and Accounting Manual*, Section 8400, "Disclosure Checklists for Corporations." These items are not all-inclusive and are not intended to present minimum requirements.

	Yes	No	N/A
Statement of Cash Flows			
1. Is a statement of cash flows presented as a basic financial statement for each period for which a statement of income is presented? [SFAS 95, par. 3 (FASB Current Text reference is not available at this time)]	___	___	___
2. Does statement of cash flows explain effect of cash flows by showing change in cash and cash equivalents? [SFAS 95, par. 7 (FASB Current Text reference is not available at this time)]	___	___	___
3. Is policy for defining what is a cash equivalent disclosed? [SFAS 95, par. 10 (FASB Current Text reference is not available at this time)]	___	___	___
4. Are major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method) presented in the statement? [SFAS 95, par. 27 (FASB Current Text reference is not available at this time)]	___	___	___
5. If the direct method of reporting net cash flow from operating activities is used, has a reconciliation of net income to net cash flow from operating activities been provided in a separate schedule? [SFAS 95, par. 30 (FASB Current Text reference is not available at this time)]	___	___	___
6. If the direct method of reporting net cash flow from operating activities is not used, has the same amount for net cash flow from operating activities been reported indirectly by adjusting net income to reconcile it to net cash flow from operating activities (the indirect or reconciliation method)? [SFAS 95, par. 28 (AC C25.126)]	___	___	___

	Yes	No	N/A
7. If the indirect method of reporting net cash flow from operating activities is used, has the reconciliation of net income to net cash flow from operating activities been reported either within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities? [SFAS 95, par. 30 (AC C25.128)]	___	___	___
Content			
1. Are cash receipts and cash payments for the following transactions classified as cash flows from investing activities:			
a. Receipts from collections or sales of loans?	___	___	___
b. Receipts from sales of property?	___	___	___
c. Loans to members?	___	___	___
d. Payments to acquire property?	___	___	___
[SFAS 95, pars. 16-17 (AC C25.114-.115)]			
2. Are cash receipts and cash payments from investing activities shown separately on statement of cash flows?	___	___	___
[SFAS 95, par. 31 (AC C25.129)]			
3. Are cash receipts and cash payments for the following transactions classified as cash flows from financing activities:			
a. Proceeds from issuing debt?	___	___	___
b. Repayments of amounts borrowed?	___	___	___
[SFAS 95, pars. 19-20 (AC C25.117-.118)]			
4. Are cash receipts and cash payments from financing activities shown separately on statement of cash flows?	___	___	___
[SFAS 95, par. 31 (AC C25.129)]			
5. Are cash receipts and cash payments for the following transactions classified as cash flows from operating activities:			
a. Interest received on loans?	___	___	___
b. Insurance proceeds except those directly related to investing or financing activities?	___	___	___
c. Interest paid to creditors?	___	___	___
d. Payments to suppliers and employees?	___	___	___
e. Payments to governments for taxes, duties, fines, and other fees or penalties?	___	___	___
f. Payments to settle lawsuits?	___	___	___
g. Contributions to charities?	___	___	___
[SFAS 95, pars. 22-23 (AC C25.120-.121)]			

	Yes	No	N/A
6. If applicable, is the effect of exchange rate changes on cash balances held in foreign currencies shown separately on statement of cash flows? [SFAS 95, par. 25 (AC C25.123)]	__	__	__
7. Are noncash investing and financing activities (i.e., converting debt to equity) summarized in a separate schedule? [SFAS 95, par. 32 (AC C25.134)]	__	__	__

CHAPTER 3

Employers' Accounting for Pensions

(FASB Statement No. 87)

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Employers' Accounting for Pensions

(FASB Statement No. 87)

1. INTRODUCTION

Issued by the Financial Accounting Standards Board (FASB) in December 1985, Statement of Financial Accounting Standards (SFAS) No. 87, *Employers' Accounting for Pensions*, establishes standards of accounting and reporting for an employer offering pension benefits to employees.

SFAS 87 applies to employers in rate-regulated industries. While rate regulation may affect the timing of recognizing net pension cost as an expense, it does not otherwise affect the requirements of SFAS 87.

The Statement supersedes the following:

- Accounting Principles Board (APB) Opinion No. 8, *Accounting for the Cost of Pension Plans* (as amended)
- SFAS No. 36, *Disclosure of Pension Information*
- SFAS Interpretation (SFAS I) No. 3, *Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974*

The Statement also amends SFAS No. 5, *Accounting for Contingencies*, on recognition of a liability upon withdrawal from a plan, and APB Opinion No. 16, *Business Combinations*, on accruing a liability for pension costs in a purchase.

SFAS 87 does not apply to plans that provide only life insurance or health insurance benefits, or both, to retirees. Nor does it apply to post-retirement health care benefits provided through a pension plan. Also, SFAS 87 does not amend or supersede APB Opinion No. 12, *Deferred Compensation Contracts*. For example, if prior to the initial application of SFAS 87, an employer appropriately categorized a deferred compensation arrangement as a deferred compensation contract rather than a pension plan, and followed the accounting specified in APB 12 rather than in APB 8, then the employer would not have to alter that accounting to comply with SFAS 87.

In addition, SFAS 87 does not apply to employers that are state and local government units or federal agencies. Instead, the statutory authority to establish financial accounting and reporting standards for federal agencies rests with various government organizations. In GASB Statement No. 4, *Applicability of FASB Statement No. 87, Employers' Accounting for Pensions to State and Local Governmental Employees*, issued in September 1986, the Government Accounting Standards Board (GASB) indicated that state and local government employers should not change their accounting and financial reporting of pension activities to comply with SFAS 87.

2. OBJECTIVES AND SUMMARY OF MODIFICATIONS TO CURRENT PRACTICE

SFAS 87 provides a measure of net periodic pension cost that reflects the terms of the underlying plan. The Statement recognizes the cost of an employee's pension over the employee's service period and calls for improvements to be made in disclosures and in the reporting of the financial position.

SFAS 87 also adopts a standardized method for measuring net periodic pension cost. The Statement requires companies to use either a single actuarial cost method or an attribution method based on the terms of the plan to determine pension cost. For final-pay and career-average-pay plans, the approach to determine pension cost is equivalent to a projected unit cost method. For flat benefit plans (that is, fixed benefits per year of service), the approach to be used is a unit credit method.

Under certain circumstances, SFAS 87 requires the immediate recognition of a minimum liability. Note that the recognition of a minimum liability does *not* affect reporting earnings; its impact is limited to the balance sheet effects on assets and equity. The minimum liability recognizes a part of the pension obligation on the balance sheet, whereas this obligation was totally unrecognized under APB 8, except for the differences between amounts funded and the Pension provision.

The Statement also expands pension-related disclosures in notes accompanying the financial statements. In addition to the descriptive information about the plan's provisions, required disclosures include such items as plan assets; employee groups covered; components of pension expense; and a reconciliation of projected benefit obligation to the pension asset or liability listed in the balance sheet. The reconciliation of the projected benefit obligation to the balance sheet asset or liability is designed to provide information on the status of the unrecognized items, including prior service cost, transition assets or liability, and unrecognized gains or losses.

SFAS 87 maintains certain fundamental aspects of current accounting for pensions. Although the accrual method should still be applied, the Statement permits delayed recognition of certain events, including plan adoption, plan amendments, and actuarial gains and losses. Deferred amounts are to be recognized using systematic amortization techniques.

Under SFAS 87, the elements of pension cost are reported as a net cost in the employer's financial statements. For example, transactions and events affecting a pension plan are reported as a single net amount, even though the disclosure of separate components is provided. The components of pension cost include—

- Service cost (i.e., compensation cost of benefits).
- Interest cost from deferral of benefits.
- Results of investing activities.
- Amortization of—
  - Unrecognized transition losses and (gains).
  - Unrecognized prior service costs.
  - Unrecognized net gains and losses.

Note that the interest cost component of net periodic pension cost is not treated as interest for purposes of applying SFAS No. 34, *Capitalization of Interest Cost.*

3. KEY DEFINITIONS OF TERMS IN THE PRONOUNCEMENT

Accumulated benefit obligation. The actuarial present value of benefits, whether vested or nonvested, attributed by the pension benefit formula to employee service rendered before a specified date and based on employee service and compensation (if applicable) prior to that date. The accumulated benefit obligation differs from the projected benefit obligation in that it includes no assumption about future compensation levels. For plans with flat benefit or nonpay-related pension benefit formulas, the accumulated benefit obligation and the projected benefit obligation are the same.

Actual return on plan assets component (of net periodic cost). The difference between the fair value of plan assets at the end of the period and the fair value at the beginning of the period, adjusted to reflect contributions and payments of benefits during the period.

Actuarial present value. The value, as of a specified date, of an amount or series of amounts payable or receivable thereafter, with each amount adjusted to reflect (a) the time value of money (through discounts for interest) and (b) the probability of payment (by means of decrements for such events as death, disability, withdrawal, or retirement) between the specified date and the expected date of payment.

Corridor approach. Actuarial gains and losses falling within a corridor which is the greater of 10% of the market-related asset value or 10% of the projected benefit obligation at the beginning of the year need not be amortized.

Defined benefit pension plan. A pension plan that defines an amount of pension benefit to be provided, usually based on one or more factors such as age, years of service, or compensation. Any pension plan that is not a defined contribution pension plan is, for purposes of this SFAS 87, a defined benefit pension plan.

Defined contribution pension plan. A plan that provides pension benefits in return for services rendered, provides an individual account, for each participant, and specifies how contributions to the individual's account are to be determined instead of specifying the amount of benefits the individual is to receive. Under a defined contribution pension plan, the benefits a participant will receive depend solely on the amounts contributed to the participant's account, the returns earned on investments of those contributions, and forfeitures of other participants' benefits that may be allocated to such participants' accounts.

Expected long-term rate of return on plan assets. An assumption as to the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation.

Expected return on plan assets. An amount calculated as a basis for determining the extent of delayed recognition of the effects of changes in the fair value of assets. The expected return on plan assets is determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets.

Explicit approach to assumptions. An approach under which each significant assumption used reflects the best estimate of the plan's future experience, solely with respect to that assumption.

Fair value. The amount that a pension plan could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, in situations other than forced or liquidation sales.

Gain or loss component (of net periodic pension cost). The sum of (a) the difference between the actual return on plan assets and the expected return on plan assets; and (b) the amortization of the unrecognized net gain or loss from previous periods. The gain or loss component is the net effect of delayed recognition of gains and losses (the net change in the unrecognized net gain or loss). Exception: it does not include changes in the projected benefit obligation occurring during the period and deferred for later recognition.

Market-related value of plan assets. A balance used to calculate the expected return on plan assets. Market-related value can be either the fair market value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years. Different ways of calculating market-related value may be used for different classes of assets, but the manner of determining market-related value must be consistently applied from year to year for each class.

Minimum pension liability. Unfunded accumulated benefit obligation required to be reported on the balance sheet beginning in 1989.

Net periodic pension cost. The amount recognized in an employer's financial statements as the cost of a pension plan for a period. Components of net periodic pension cost are service cost, interest cost, actual return on plan assets, gain or loss, amortization of unrecognized prior service cost, and amortization of the unrecognized net obligation or asset existing at the date of initial application of SFAS 87. This Statement uses the term "net periodic pension cost" instead of "net pension expense" because part of the cost recognized in a period may be capitalized along with other costs as part of an asset, such as inventory.

Periodic pension cost. The pension cost is the net of six components: service cost, interest cost, return on plan assets, amortization of prior service cost, amortization of net gains and losses, and amortization of the net asset or obligation arising at the transition.

Projected benefit obligation. The actuarial present value, as of a specified date, of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using assumptions about future compensation levels, if the pension benefit formula is based on those future compensation levels (i.e., pay-related, final-pay, final-average-pay, or career-average-pay plans).

Settlement rates. Assumed interest rates at which pension benefits could be effectively settled. Rates could be based on—

- Rates implicit in annuity contracts.
- Pension Benefit Guaranty Corporation rates.
- Rates on high-quality, fixed-income investments available during the period to maturity of the pension benefits.

The settlement rate is used to discount pension benefit obligations and to compute service and interest cost components of periodic pension cost.

Transition amount. The difference between plan assets, adjusted for balance sheet prepayments and accruals, and the projected benefit obligation at the date SFAS 87 is adopted. The amount, a net asset or a net obligation, is amortized over a future period.

4. ACCOUNTING FOR SINGLE EMPLOYER BENEFIT PENSION PLANS

The following components factor into the determination of the net periodic pension cost for single employer benefit pension plans: service cost; interest cost; actual return adjusted to expected return on plan assets; amortization of prior service cost, if any; gain or loss, including changes in assumptions, to the extent recognized; and amortization of unrecognized obligation (and loss or cost) or unrecognized net asset (any gain) existing at the initial application date of SFAS 87.

4.1 Service Cost

The service cost is the actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the period. Conceptually, the service cost component is the same for an unfunded plan, a plan with minimal funding, and a well-funded plan.

4.2 Methods of Attribution

The determination of service cost requires a method of attribution. Pension benefits should be attributed to periods of employee service based on the plan's benefit formula and the extent to which that formula states or implies attribution.

Benefit over years-of-service is the attribution approach applicable to a benefit formula that defines benefits similarly for all years of service. For final-pay and career-average-pay plans, the attribution approach is the same as the "projected unit credit" or "unit credit with service pro-rated" actuarial cost method. For a flat benefit plan, the attribution approach is the same as the "unit credit" actuarial cost method.

If there is significant backloading of benefits (that is, a delay in earning benefits), then the projected benefit obligation should accumulate on a straight-line basis.

A history of regular increases in nonpay-related benefits or benefits under a career-average-pay plan may indicate a present commitment to make future amendments. In such cases, the substantive commitment should be the basis for the accounting.

If the plan's benefit formula does not specify attribution to periods, then attribution should be as follows:

- For benefits includible in vested benefits, use a ratio of completed years of service to the minimum number of years for vesting.
- For benefits not includible in vested benefits, use a ratio of completed years of service to total projected years of service.

Some additional guidance in determining service cost is as follows:

- If a pension plan provides employees with a pension benefit equal to one percent of each year's salary, then the plan essentially is a career average, and the projected unit credit method is used.
- If a plan has a career-average-pay formula of one percent of each year's salary for that year's service, and increased benefits are pro-

vided every three years when the union contract is renegotiated, then these benefit increases are earned prospectively and represent a flat benefit. For the career-average portion of the plan, the projected unit-credit method of attribution is employed; the flat benefit portion uses a unit credit method for the limited service period.

- A plan provides for the accrual of benefits of one percent of final pay, multiplied by years of service up to 20 years but no further, with final pay frozen at year 20. Also, assume that employees' expected service exceeds 20 years. Under such a situation, the service cost component would be zero after year 20; however, interest cost would continue to accrue.

4.3 Explicit Assumptions in Arriving at Service Cost

The determination of service cost involves the use of some significant assumptions. SFAS 87 requires that each significant assumption necessary to determine annual pension cost, such as discount rates, return on plan assets, or future salary increases, reflect the best estimates with respect to that individual assumption. In addition, all assumptions presume that the plan will continue in effect in the absence of evidence to the contrary.

The assumed discount rate should reflect the rate at which pension benefits could be effectively settled. For example, each year the rates must be reevaluated to determine if they reflect the best estimate, and not an arbitrary average of a range of rates. Rates implicit in current annuity contracts, including information about available annuity rates published by the Pension Benefit Guaranty Corporation, can be used to establish discount rates. Rates of return on high-quality, fixed-income investments that are currently available and are expected to be available during the period to maturity can also be reviewed.

The decision to use a particular methodology in a particular year does not mean that the employer is locked into using that same methodology in future years. If selecting the discount rate, that rate should be the best possible estimate available. Changes in methodology should be made when warranted by changing facts or circumstances, for instance, if annuity rates seem to be more appropriate than double-A bond rates in establishing settlement rates. Such a method change to determine rates is viewed as a change in estimate, the estimate being the determination of the effective settlement rate.

Note that different rates may be used for vested, accumulated, and projected benefits, if justified. In addition, it is not always necessary for assumed compensation levels to change when assumed discount rates change. However, the two must be consistent to the extent that both incorporate expectations of the same future economic conditions.

4.4 Future Compensation Levels for Projected Benefit Obligations (Final-Pay and Career-Average-Pay Plans)

The service cost component should reflect future salary levels. This assumption is required for pay-related benefit formulas because, under this type of plan, the benefit payments are based on employees' future pay. Assumed compensation levels should include salary increases attributable to general price levels, productivity, seniority, promotion, and other factors.

However, note that the accumulated benefit obligation is measured without regard to future compensation levels.

4.5 Interest Cost

The interest cost component of periodic net pension cost is the increase in the projected benefit obligation due to the passage of time. The interest cost is determined by multiplying the projected benefit obligation by the settlement rate. The interest cost component should take into consideration changes in the pension obligation arising during the year for services rendered and benefit payments.

4.6 Actual Return on Plan Assets

The actual return on plan assets represents the change in the fair value of plan assets during the year, adjusted for the period's contributions and benefit payments. The actual return is calculated as follows:

	Fair value of assets at the end of the period
+	Benefit payments
	Total
−	Contributions
−	Fair value of assets at beginning of year
=	Actual return on plan assets

4.7 Measurement of Plan Assets

Plan assets are measured at their fair values as of the measurement date, that is, the date of the financial statements or, if used consistently, a date not more than three months prior to that date. The fair value of an asset is the amount that a plan could reasonably expect to receive in a voluntary sale (for example, market price, selling price of similar assets, and expected discounted cash flow).

4.8 Expected Return

The net periodic pension cost is based on the expected return on plan assets, which, in turn, is determined by multiplying the market-related value of plan assets at the beginning of the year, by the expected long-term rate of return expected to be earned on funds invested. Therefore, it is important to consider both the amount and timing of contributions and benefit payments expected to be made during the year.

The market-related value can be either the fair market value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years.

The use of a market-related value affects the determination of net periodic pension cost in two ways. First, the market-related value is the basis upon which the expected return on plan assets is computed. Second, to the extent that unrecognized gains and losses based on the fair value of plan assets are not yet reflected in the market-related value, such amounts are excluded from unrecognized net gain or loss and amortization commencing the following year. In other words, their impact is delayed.

As of the initial application of SFAS 87, the beginning market-related value of plan assets can be a calculated value, although it is preferable to start with the fair value at the date of transition; this is also the basis to determine the unrecognized obligation or net assets at transition. If a calculated value is used, a careful record must be kept of the unrecognized gain or loss not included in market-related value in order to avoid amortizing the difference between the fair value and a calculated value. In theory, it is best to use the fair value because SFAS 87 represents a fresh start on pension accounting.

If an employer has several plans with similar assets, the employer should not use different market-related asset valuation methods. However, different methods may be used for different classes of assets.

4.9 Amortization of Unrecognized Prior Service Cost

Prior service costs arise from plan amendments, including the initiation of a plan, that grant increased benefits based on service rendered in a prior period (a retroactive benefit). The prior service cost is measured as the increase in the projected benefit obligation as of the amendment date. The prior service cost is not charged to prior periods but instead is amortized over an assumed future benefit period. Once an amortization method is established, the amortization method remains the same unless circumstances change, such as in curtailment or if the benefit period changes. Note that an employer may not adopt a policy of immediately recognizing the cost of all plan amendments that grant increased benefits for prior service.

The amortization schedule should not be revised due to ordinary variances in expected service lives of employees.

Prior services are amortized by assigning an equal amount to each future service period of each employee who is active at the amendment date and who is expected to receive benefits under the plan. To simplify such amortizations, alternative amortization approaches are acceptable, if they result in more rapid amortization and are consistently applied. A history of regular plan amendments may call for shorter periods of amortization. Plan amendments that reduce benefits first reduce any existing unrecognized prior service cost, and then the excess, if any, is amortized on the same basis as the cost of the benefit increases.

4.10 Gains and Losses to the Extent Recognized

The gain and loss component of pension expense consists of differences between estimated and actual results of two separate components: actuarial assumptions related to the projected benefit obligations and return on plan assets. These components will be referred to in this chapter as additional projected benefit obligations (PBO) (gains) and losses, and as asset (gains) and losses. Such gains and losses do not require recognition in the period in which they arise, but instead are amortized over future years of active service. A company also may adopt a method to write off these gains and losses as they occur.

4.11 Asset (Gains) and Losses

Asset gains and losses are the differences between the actual return and the expected return during a period.

- Changes reflected in the market-related value of assets.
- Changes not reflected in the market related value (that is, the fair value minus the calculated value of plan assets).

These distinctions are critical, since asset (gains) and losses not incorporated in market-related values as of the beginning of the period are *not* subject to amortization. This exclusion results in a leveling of the income effects of fluctuating asset values.

An employer can immediately recognize asset (gains) and losses instead of delaying recognition. However, the method used must be consistently applied to all gains and losses and must be disclosed.

4.12 PBO (Gains) and Losses

PBO (gains) and losses are changes in the projected benefit obligations resulting from—

- Changes in such obligation-related assumptions as discount rates and future compensation levels.
- Variances between actual and assumed experience, as in mortality rates or turnover.

4.13 Determination of Minimum Amortization

At any given measurement date, the unrecognized gains and losses are the sum of the unamortized gains and losses from asset (gains) and losses from PBO (gains) and losses. A minimum amortization of unrecognized gains and losses (excluding any part not reflected in the market-related value) is required if the unrecognized net gain or loss at the beginning of the year exceeds 10 percent—the corridor—of the greater of—

- The projected benefit obligation as of the beginning of the year.
- The market-related value as of the beginning of the year.

The minimum amount to be amortized, if required, is the amount in excess of the corridor, as determined above, divided by the average remaining service period of active employees expected to receive benefits.

Alternative methods of amortizing unrecognized gains and losses are permissible if—

- The alternative method is consistently applied.
- The method is similarly applied to both gains and losses.
- The method is disclosed.

However, the minimum under the corridor method must be used in any period in which the minimum amortization is greater than the alternative calculation.

4.14 Gains and Losses Recognized in Arriving at Net Periodic Cost

The difference between the actual return on plan assets and the expected return should be deferred. This deferral adjusts the actual return on plan assets to the expected return on plan assets. Using the corridor method or an alternative amortization approach, a portion of the unrecognized net gains and losses from previous periods—that is, asset (gains) and losses and PBO (gains) and losses—are recognized and then included as a component of net periodic pension cost.

4.15 Transition Amounts

For a defined benefit plan, the employer determines as of the measurement date (no more than three months prior to the beginning of the fiscal year in which SFAS 87 is first applied) the projected benefit obligation and the fair value of plan assets (a) increased by any previously recognized, unfunded accrued pension cost or (b) reduced by any previously recognized, prepaid pension cost.

In determining the unrecognized net asset or net obligation at the initial application date of SFAS 87, the previously recognized, unfunded accrued or prepaid cost balance includes—

- Cumulative differences between amounts funded and expensed under APB 8.
- The remaining gross amount of any pension liability or asset recognized as part of a purchase business combination.
- Any unamortized credit resulting from an asset reversion.

- Any liability for special termination benefits to be paid by the plan.
- Any remaining portion of a pension liability recognized as part of the accounting for the disposal of a segment of a business.

4.16 Amortization of Transition Amounts

The unrecognized net obligation or asset determined at the initial application date of SFAS 87 is amortized on a straight-line basis, over the average remaining service period of employees expected to receive benefits under the plan. However, if the average remaining service period is less than 15 years, the employer may elect to replace it with a 15-year period.

Note that an employer should not use different amortization periods for plans with essentially similar employee groups without justifying a need for such differences. In addition, employees who are expected to be terminated before their benefits are vested are excluded when calculating the average remaining service period.

5. RECOGNITION OF LIABILITIES AND ASSETS

A liability for unfunded accrued pension cost is recognized if the net periodic accrued costs exceed the amounts contributed to the plan. Conversely, an asset for prepaid pension cost is recognized if the amounts contributed to the plan exceed the net periodic accrued costs.

5.1 Additional Minimum Liability

SFAS 87 contains a minimum liability provision that requires the company to record an additional minimum liability under certain conditions. For example, an unfunded accumulated benefit obligation exists if the accumulated benefit obligation, which is calculated without salary progressions, exceeds the fair value of plan assets. In this situation, a liability, including unfunded accrued pension costs, that is at least equal to the unfunded accumulated benefits must be recognized. Recognition of an additional minimum liability is required if an unfunded accumulated benefit obligation exists, and—

- There is a prepaid cost, or
- The unfunded accrued pension cost is less than the unfunded benefit obligation, or

- No accrued or prepaid pension cost has been recognized.

If a calendar-year company uses a September 30 measurement date, the liability requirement under SFAS 87 should be calculated based on the unfunded accrued pension cost (or the prepaid pension cost) as of December 31, adjusted for fourth-quarter funding (or negative funding) and for the results of any fourth-quarter settlement, curtailment, or termination benefits.

5.2 Intangible Asset

If an additional minimum liability is recognized, then an equal amount is recognized as an intangible asset. However, the intangible asset cannot exceed the amount of the unrecognized prior service cost. For purposes of this calculation, unrecognized prior service cost is increased by any remaining unrecognized net obligation generated upon adopting SFAS 87. Any amounts in excess of these limits are viewed as unrecognized losses and are reported as separate components of stockholders' equity, net of any tax benefits from treating such losses as temporary differences, as specified under SFAS No. 96, *Accounting for Income Taxes.*

Each year, the amount of additional minimum liability must be determined, and required changes in reported balance sheet amounts have no impact on earnings. The effective date for implementation of the additional minimum liability is for fiscal years beginning after December 15, 1988.

6. MEASUREMENT DATES

Plan assets and obligations may be measured as of the date of the financial statements, or, if used consistently, a date not more than three months prior to the date of the financial statements. If actuarial valuations at the plan's year end differ from the employer's measurement date, an additional valuation is not necessarily required. If by rolling forward a prior valuation to the measurement date an employer is assured that the reliability of a pension obligation is sufficiently high, then a full actuarial valuation is not required to measure the pension obligation. Note that plan assets cannot be rolled forward but must be based on the actual measurement.

Those actuarial assumptions used should be appropriate as of the measurement date. The objective is to determine the various pension measurements, including plan assets, as of a particular date.

If a company uses a September 30 measurement date and adopts SFAS 87 on January 1, 1987, the company must reflect plan operations from September 30, 1986, to September 30, 1987, in its financial statements.

Information can be prepared at an earlier date and then projected forward to account for subsequent events (for example, employee services).

The net periodic pension cost for both interim and annual statements should be based on assumptions used the previous year, unless more recent measurements are available or a significant event that would call for a new measurement has occurred. The additional minimum liability in interim statements should be the same as in previous year end statements, adjusted for accruals and contributions, unless more current measures are available or a significant event requiring remeasurement has occurred.

7. DISCLOSURES

7.1 Description of a Plan

A description of the plan(s) should be provided, including:

- Employees groups covered
- Type of benefit formula
- Funding policy
- Types of assets held and significant non-benefit liabilities, if any
- Nature and effect of significant matters affecting comparability

7.2 Components of Pension Cost

Components of the net periodic pension cost, including service cost, interest, actual return on assets, and net total of all other components, must be disclosed. The net total of all other components consists of—

- A deferred gain or loss of the period (in effect, an offset to the actual return, thereby converting actual cost to expected cost).
- Amortization of asset (gains) and losses, and of PBO (gains) and losses.
- Amortization of unrecognized prior service cost.
- Amortization of net obligation or net asset at transition.

7.3 Reconciliation of Funded Status

SFAS 87 requires a schedule reconciling a plan's funded status (that is, the difference between the projected benefit obligation and plan assets) with amounts reported in the balance sheet. That schedule should separately show—

- The fair value of plan assets.
- The projected benefit obligation identifying the accumulated benefit obligation and the vested benefit obligation.
- The amount of unrecognized prior service cost.
- The amount of unrecognized net gain or loss, including asset gains and losses not yet reflected in the market-related value.
- The amount of any remaining unrecognized net obligation or net asset existing at the initial application date of SFAS 87.
- The amount of any additional liability recognized.
- The amount of net pension asset or liability recognized in the statement of financial position, which is the net result of combining the preceding six items.

7.4 Weighted Average Assumed Discount Rate

Under SFAS 87, information is to be provided about the weighted average assumed discount rate, the rate of compensation increase (if applicable), and the expected long-term rate of return on plan assets.

Assumed discount rates and rate of compensation increases should be as of the year-end measurement date for which the projected benefit obligation is determined. The assumed long-term rate of return on plan assets normally is determined as of the beginning of the year measurement date; therefore, the rate normally is determined as of the beginning of the year measurement date.

7.5 Significant Non-benefit Liabilities

Significant non-benefit liabilities include—

- Unsettled security purchases.
- Unsecured borrowings.

- Borrowings secured by real estate investments.
- Accrued administrative expenses.

7.6 Other Disclosures

If applicable, a company should indicate the following:

- The amount and type of securities of both the employer and related parties included in the plan assets.
- The approximate amount of annual benefits covered by annuities issued by the employer and related parties.
- Alternative amortization methods used, and the existence of commitments for increases in nonpay-related benefits.

A segregation of the pension disclosures by plans and by measurement date is not required. However, disclosure should be made of the different measurement dates used.

7.7 Initial Application

In the year of initial application of SFAS 87, the employer should also disclose the effect of applying SFAS 87. For instance, assume that an employer initially applies SFAS 87 in 1986. In addition to disclosing the net periodic pension cost specified under SFAS 87, the employer also discloses the pension cost that would have been determined for 1986 using APB 8. A similar disclosure is also called for in interim reports in the year of initial application. The effect of adopting the new accounting principle on income before extraordinary items and/or net income (and on per share amount) of the period of change should be disclosed.

SFAS 87 is to be applied prospectively; therefore, an employer is not required to provide pro forma disclosures normally required under APB Opinion No. 20, *Accounting Changes.*

It is permitted, but not required, to replace the disclosures for the year prior to applying SFAS 87 with those that would be prepared under the new pronouncement. For instance, an employer can disclose for the prior year either the SFAS 36 disclosures originally reported, or the vested, accumulated, and projected benefit obligations as measured in accordance with SFAS 87 and the fair value of plan assets at year end. Essentially, these substituted disclosures are the components of the funded status of the plan as of the initial application date of SFAS 87. Also, the weighted average assumed discount rates and compensation increase both should be disclosed.

8. EMPLOYERS WITH TWO OR MORE PLANS

The provisions of SFAS 87 are to be applied separately to each plan. Unless the right to transfer assets exists, underfunded plans may not be combined with overfunded plans. As a general rule, disclosures of amounts under SFAS 87 may be aggregated. However, for purposes of presenting a funded status, the aggregate amounts for plans with assets in excess of accumulated benefits should be shown separately from the aggregate amounts for plans that have an accumulated benefit obligation exceeding plan assets.

9. ANNUITY CONTRACTS

If benefit currently earned are covered by nonparticipating annuity contracts, the cost of the annuity contract is the measure of the service component. Annuity contracts and related benefits are excluded from projected benefit obligation, accumulated benefit obligation, and plan assets.

Insurance contracts depending on provisions may be viewed either as annuity contracts or as investments. If accounted for as investments, these contracts are measured at fair value.

10. DEFINED CONTRIBUTION PLANS

The periodic net pension cost generally equals the contribution required, if it is for periods in which the individual has rendered service. Disclosures for defined contributions include descriptions of plans; the basis for making contributions; significant matters affecting comparability; and the amount of cost recognized.

11. MULTI-EMPLOYER PLANS

For multi-employer plans, the amount of net pension cost is the required contribution for the period. A liability is recognized for unpaid contributions. Required disclosures for each multi-employer plan in which a company participates include plan description; employee groups covered;

types of benefits; matters affecting comparability; and the amount of cost. If withdrawal giving rise to a liability is either probable or reasonably possible, then the provisions of SFAS 5 apply.

12. NON-U.S. PLANS

Except for a later effective date, there are no special provisions for non-U.S. plans. Non-U.S. plans are subject to the provisions of SFAS 87 if "those arrangements are in substance similar to pension plans in the United States."

13. BUSINESS COMBINATIONS

In a business combination accounted for as a purchase under APB Opinion No. 16, *Business Combinations*, the acquired company remeasures its projected benefit obligation and the fair value of plan assets at the date of acquisition, and the difference between those two amounts included in the allocation of the purchase price as either a net liability or a net asset. Following the business combination, any previously unrecognized net gains or losses, unrecognized prior service cost, and unrecognized net obligations or assets, which were on the books of the acquired company at the transition date are now eliminated for financial reporting purposes.

If a termination or curtailment is expected, their effects are considered in the measurement of the projected benefit obligation.

The asset or liability recognized by the acquiring employer is not amortized separately. Rather, it is affected by the accounting for the pension plan in future periods. A pension asset representing overfunding at the acquisition date is credited each year in which (a) net periodic pension costs exceeds employer contributions or (b) there is an asset reversion. A pension liability representing underfunding at the acquisition date is debited each year in which (a) employer contributions exceed net periodic pension cost or (b) net periodic pension income results from either a settlement or a curtailment gain.

In a purchase combination, if the acquired enterprise does not have a pension plan, and the acquiring enterprise admits the employees of the acquired enterprise to its pension plan and grants them credit for prior service, then this transaction will be treated as part of the purchase cost, as long as granting the credit was an integral part of the agreement and was reflected in its written terms. Otherwise, the transaction will be treated as a plan amendment.

If an acquiring employer recognized a pension liability at the date of an acquisition that occurred prior to the initial application of SFAS 87, that liability should be considered in determining the unrecognized net obligation or net asset at the initial application of SFAS 87. If at the date of an acquisition but less than one year before the initial application of SFAS 87, an acquiring employer did not assign a portion of the purchase price to an asset for the acquired employer's known overfunded plan, then the amount should be reflected in the unrecognized net obligation or net asset determined at the initial application date of SFAS 87. Note that the one-year valuation period of SFAS No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprise* does not apply because the company was not waiting for an appraisal.

14. EFFECTIVE DATES

The effective dates of SFAS 87 are—

Fiscal Years Beginning After 12/15

	All Provisions But Minimum Liability	*Minimum Liability*
Public companies	1986	1988
Nonpublic U.S. companies with more than 100 participants	1986	1988
Nonpublic U.S. companies with no more than 100 participants	1988	1988
Non-U.S. plans	1988	1988

The application of SFAS 87 is prospective; therefore, the restatement of previously issued annual financial statements is not permitted. If the pronouncement is not adopted in the first quarter, the previous quarters will require retroactive restatement. At the required adoption date, the provisions of SFAS 87 must be applied as of the first quarter.

Early adoption for non-U.S. plans must be on a country-by-country basis, that is, SFAS 87 must be applied to all plans in a country for which the election is made.

15. PRACTICE AIDS IN APPLYING SFAS 87

The following set of Practice Aids (Schedules 1 to 12) are designed to help the accountant gather and document information about pension-related costs included within financial statements. This is immediately followed by a case study, which utilizes these practice aids. The case is designed to clarify measurement rules and accompanying disclosures required under SFAS 87. The case presumes that the company in question has adopted the pronouncement in the preceding year.

Schedule 1. Pension-related balance sheet values: opening balances

Projected benefit obligation$_{T-1}$
Plan assets at fair value$_{T-1}$
  Funded status$_{T-1}$
Unrecognized net (asset)/obligation at transition$_{T-1}$
Unrecognized prior service cost$_{T-1}$
Unrecognized net (gain) or loss$_{T-1}$
(Accrued) or prepaid pension cost before additional minimum liability$_{T-1}$

T-1 = Beginning of year
T = End of year
( ) = credit

Schedule 2. Reconciliation of projected benefit obligation (PBO)[1]

Projected benefit obligation$_{T-1}$
+ Service cost[2]
+ Interest cost[3]
− Benefits paid
+ Prior service costs arising from plan amendments during current period
+ Additional unrecognized PBO (gains) and losses[4]
= Projected benefit obligation$_T$

[1]The projected benefit obligation as of a particular date is the actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using an assumption as to future compensation levels, if the benefit formula is based on the future compensation.

[2]Service cost is the actuarial present value of benefits attributed by the pension benefit SFAS formula to employee service during a period. SFAS 87 prescribes a standardized method for determining annual service cost. The calculation of the annual service cost involves various uses of an attribution method as well as assumptions and estimates as to future events affecting the amount and timing of future benefits.

[3]Interest cost is the increase in the projected benefit obligation due to the passage of time. Generally, this component is the projected benefit obligation as of the beginning of the year, multiplied by the average discount rate at the beginning of the year. However, the actual amount of interest cost can differ when taking into account the effects of benefit payments and services rendered during the year.

[4]Additional unrecognized PBO (gains) and losses result from changes in projected benefit obligations (PBO) arising from changes in assumptions (i.e., discount rates) and from differences between actual and assumed experience (i.e., turnover, mortality, and wage levels).

T-1 = Beginning of year
T = End of year
( ) = credit

Schedule 3. Reconciliation of actual return on plan assets

Plan assets$_{T\text{-}1}$
\+ Contributions
− Benefits paid
\+ or − Actual Return[1]
= Plans assets$_T$

[1]Actual return on plan assets is the difference between the fair value at the end of the period and the fair value at the beginning of the period, adjusted for contributions and payments of benefits during the period.

T-1 = Beginning of year
T = End of year

Schedule 3A. Calculation of net asset gain or loss unrecognized during period

Actual return (loss) during period
− Expected return on plan assets[1]
= Net asset gain or (loss) unrecognized during period

[1]The expected return on plan assets is defined in SFAS 87 as, "An amount calculated as a basis for determining the extent of delayed recognition of the effects of changes in the fair value of assets. The expected return on plan assets is determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets."

The market-related value can be either fair value (i.e., actual plan assets) or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years.

( ) = credit

Schedule 4. Amortization of transition amount

Unrecognized transition amount$_{T\text{-}1}$
− Amortization for current period
= Unrecognized transition amount$_T$

T-1 = Beginning of year
T = End of year

Schedule 5. Amortization of unrecognized prior service cost

Unrecognized prior service $\text{cost}_{T\text{-}1}$
+ Prior service cost arising from plan amendments during the current period[1]
− Amortization of prior service cost
= Unrecognized prior service cost_{T}

[1]Prior service cost is the increase in projected benefit obligations due to a plan amendment. Prior service costs can be amortized by assigning equal amounts to each future period of service of each employee who is expected to receive plan benefits and who is active at the date of the amendment. If almost all plan participants are inactive, prior service cost is amortized based on remaining life expectancy. Other more accelerated amortization methods are available. A separate amortization schedule is maintained for each amendment giving rise to a prior service cost.

T-1 = Beginning of year
T = End of year

Schedule 6. Components of pension expense

Service cost	Schedule 2
+ Interest cost	Schedule 2
− Expected return on assets:	Schedules 3 and 3A
Actual return	
− Net asset gain or (loss) unrecognized during period	
+ Amortization of:	
Unrecognized transition losses and (gains)	Schedule 4
Unrecognized prior service costs	Schedule 5
Unrecognized net (gains) and losses	Schedule 7

( ) = credit

Schedule 7. Unrecognized net gains or losses

Unrecognized net (gains) or $\text{losses}_{T\text{-}1}$	
+ Net asset (gain) or loss unrecognized during period[1]	Schedule 3A
+ Additional unrecognized PBO (gains) and losses	Schedule 2
− Amortization (based on beginning period amount)	
= Unrecognized net (gains) or losses_{T}	

[1]The difference between the actual return and the expected return.

T-1 = Beginning of year
T = End of year
( ) = credit

Schedule 8. Corridor amortization

The minimum amortization of unrecognized net gains or losses is provided under the corridor method, which requires amortization only if the unrecognized net gain or loss as of the beginning of the year exceeds 10 percent of the greater of (a) the projected benefit obligation or (b) the market-related value of plan assets. If amortization is required, the minimum is the excess divided by the average remaining service period of active employees expected to receive benefits under the plan. If all or almost all the plan's participants are inactive, the average remaining life expectancy of the inactive participants is used. Other systematic methods may be used in lieu of the minimum if the method (a) results in a larger amortization (b) is applied consistently (c) is applied to both gains and losses and (d) is disclosed.

Unrecognized net (gains) or losses$_{T-1}$[1]
– Corridor (10 percent of greater of PBO$_{T-1}$ or market-related value plan assets$_{T-1}$)
Excess above corridor
Amortization period
Amount amortized

[1]Unrecognized net (gains) or losses at any measurement date consists of the unamortized portion of sum of recognized PBO (gains) and losses from previous periods and net asset (gains) or losses unrecognized in previous periods.

T-1 = Beginning of year
( ) = credit

Schedule 9. Pension-related balance sheet values: ending balances

Projected benefit obligation$_T$
Plan assets at fair value$_T$
Funded status$_T$
Unrecognized net (asset)/obligation at transition$_T$
Unrecognized prior service cost$_T$
Unrecognized net (gain) or loss$_T$
(Accrued) or prepaid pension cost before additional minimum liability$_T$

T = Beginning of year
( ) = credit

Schedule 10. Balance sheet summary

Accrued/prepaid pension cost
Additional liability
Intangible asset
Equity component

Schedule 11. Calculation of minimum additional liability

Accumulated benefit obligation$_T$[1]
− Plan asssets$_T$
Minimum liability$_T$
− Accrued pension cost or (Prepaid Pension Cost)[2]
Required additional liability[3]

[1]Accumulated benefit obligation is basically the projected benefit obligation reduced by the effects of estimated future salary increases.

[2]If there exists an excess of an accumulated benefit obligation above plan assets and there is a prepaid pension cost on the books, then the minimum liability is the sum of these amounts.

[3]An employer required to recognize a minimum liability will recognize an intangible asset to the extent of any recognized prior service cost at the measurement date. Additional minimum liability is excess of prior service costs is reported as a reduction of equity.

T = End of year

Schedule 12. Format to prepare required disclosures

	Disclosure
Footnotes:	*12/31/88*
Reconciliation:	
Vested benefit obligation	
plus nonvested accumulated benefits	$________
Accumulated benefit obligation	
plus effect of projected increases	________
Projected benefit obligation	
Plan assets (fair value)	________
Funded status	
Deferred transition loss	
Prior service cost	
Unrecognized loss	
Additional liability	________
Net pension liability on statement	
of financial position	========
Pension Expense:	
Service cost	
Interest expense	
Actual return on plan assets	
All other components	________
Total	========
Journal entries:	
Pension expense	________
Cash	________
Accrued expense	________
Additional liability	________
Intangible asset	________

16. CASE STUDY ON MEASUREMENTS AND DISCLOSURES REQUIRED UNDER SFAS 87

Empwel Corporation (the Company) provides its employees with a defined benefit plan covering substantially all of its employees. The Company adopted SFAS 87 as of January 1, 1987. The following information is available:

	1988
Service cost	$ 400,000
Interest and settlement rate: 10%	?
Actual return	?
Prior service cost amortization	160,000
Transitional obligation amortization	15,000
Contributions	522,059
Benefits paid	333,000
Expected return	8%
Fair value plan assets 12/31/88	3,639,059
Average remaining service life active employees	15 years
Fair value is used as marketed-related value	
Additional unrecognized PBO losses in 1988	280,000
Accumulated benefits 12/31/88	4,292,600
Vested benefits 12/31/88	$2,897,505
Opening Balances 1/1/88	
Accrued pension obligation	$ 250,000
Additional liability	200,000
Intangible asset	200,000
Projected benefit obligation (PBO)	4,562,500
Plan assets	3,000,000
Unrecognized transitional obligation	150,000
Prior service cost	500,000
Unrecognized net losses	662,500
Accumulated benefit obligation	$3,562,500

16.1 Opening Pension-Related Balances

Exhibit 3-1 analyzes the opening pension-related balances as of 1/1/88.

Exhibit 3-1 *Pension-Related Balance Sheet Values: Opening Balances*

Projected benefit obligation$_{T-1}$	$(4,562,500)
Plan assets at fair value$_{T-1}$	3,000,000
Funded status$_{T-1}$	(1,562,500)
Unrecognized net (asset)/obligation at transition$_{T-1}$	150,000
Unrecognized prior service cost$_{T-1}$	500,000
Unrecognized net (gain) or loss$_{T-1}$	662,500
(Accrued) or prepaid pension cost before additional minimum liability$_{T-1}$	$ (250,000)

Additional Minimum Liability: Opening Balance

Plan assets at fair value$_{T-1}$	$ 3,000,000
Accumulated benefit obligation$_{T-1}$	(3,450,000)
Minimum liability	$ (450,000)

T-1 = Beginning of year balances
T = End of year
( ) = Credit

Exhibit 3-1 Discussion. A fundamental relationship is that the difference between pension benefit obligations and plan assets (funded status) equals the sum of the amounts of—

- Unrecognized transitions gains or losses.
- Unrecognized prior service costs.
- Unrecognized gains or losses.
- Accrued or prepaid pension costs.

The unrecognized amounts can be thought of as off the books. On the other hand, consider the accrued or prepaid items as reflected on the books. Under circumstances discussed in a subsequent section, the prepaid or accrued pension costs are adjusted to recognize a minimum liability. The minimum liability at the beginning of the year is $450,000.

The reconciliation shown in Exhibit 1 appeared in the earlier year's pension disclosure footnote.

16.2 Reconciliation of Beginning and Ending Balances

Exhibit 3-2 is a reconciliation of the beginning and ending balances in the pension benefit obligation.

Exhibit 3-2 *Reconciliation of Projected Benefit Obligation (PBO)*

Projected benefit obligation$_{T-1}$	$4,562,500
+ Service cost	+400,000
+ Interest cost	+456,250
− Benefits paid	−333,000
+ Prior service costs arising from plan amendments during current period	0
+ Additional unrecognized PBO (gains) and losses	+280,000
= Projected benefit obligation$_{T}$	$5,365,750

- Interest cost = .10 ($4,562,500).
- The discount rate represents the rate at which the pension benefits could be effectively settled.
- The $280,000 in additional unrecognized losses will be explained later on.

Exhibit 3-2 Discussion. The $4,562,500 and $5,365,750 represent beginning-of-the-year and end-of-the-year projected benefit obligations (i.e., plan obligations) using as the measurement date the date of the financial statements. Using the schedules, note that the service costs, interest costs, and additional unrecognized PBO losses increase beginning-of-the-period projected obligations. Benefits paid decrease those obligations. SFAS 87 generally requires measurements as of the financial statement date or, if consistently applied, as of a date not more than three months before fiscal year end. The $400,000 service cost is the pension benefits earned by employees for rendering services and represents the actuarial present value of benefits attributed by the pension benefit formula to employees' service rendered during the year. The calculation was made by the actuary using participant data supplied by the company.

Management assumes a 10-percent settlement rate in arriving at an interest cost of $456,250. This rate is comparable to those published by the Pension Benefit Guaranty Corporation. The interest cost is a component of pension cost attributable to the increase in projected benefit obligation due to the passage of time.

There are no new increases in prior service costs from plan amendments in the current year. The derivation of the $280,000 in unrecognized PBO losses is explained in a subsequent exhibit.

16.3 Reconciliation of Actual Return on Assets and Unrecognized Net Gain

Exhibit 3-3 is a reconciliation of actual return on plan assets, while Exhibit 3-3A calculates the unrecognized net gain for the period.

Exhibit 3-3 *Reconciliation of Actual Return on Plan Assets*

Plan assets$_{T-1}$	\$3,000,000
+ Contributions	522,059
− Benefits paid	−333,000
+ or − Actual return	450,000
Plans assets$_T$	\$3,639,059

T-1 = Beginning of year
T = End of year

Exhibit 3-3A *Calculation of Net Asset Gain or Loss Unrecognized During Period*

Actual return (loss) during period	\$450,000
− Expected return on plan assets (.08) (3,000,000)	−240,000
Net asset gain or (loss) unrecognized during period	\$210,000

- Although the actual return on plan assets is disclosed, the net pension cost is based only on the expected return on plan assets.
- Unrecognized net asset gain or loss is shown to be a component of pension expense through amortization under the corridor method.

Exhibit 3-3 Discussion. Pension plan assets in the beginning of the period were increased by company contributions of \$522,059 and actual returns on investments of \$450,000. Benefits paid during the period were \$333,000. The actual return is the difference between plan assets at the beginning and end of the year, adjusted for contributions and benefits paid. The actual return on investments reduces the pension expense. The period-by-period amount by which return on investments reduces the current period's pension provision can be based on an expected return rather than on the actual return for the period. This constitutes a smoothing device, which is permissible under SFAS 87. The Company has elected this available option under SFAS 87 and calculates expected return using an expected rate of return of 8 percent on actual plan assets (i.e., market-related value) at the beginning of the period, totaling \$3,000,000. Pension expense for the period is reduced by the expected return of \$240,000, and the \$210,000 difference between the actual return and the expected return is an unrecognized asset gain emerging during the period.

16.4 Amortization of Transition Amounts and Prior Period Service Costs

Exhibits 3-4 and 3-5 provide schedules amortizing transition amounts and prior period service costs.

Exhibit 3-4 *Amortization of Transition Amount*

Unrecognized transition amount$_{T-1}$	$150,000
− Amortization for current period	−15,000
Unrecognized transition amount$_T$	$135,000

T-1 = Beginning of year
T = End of year

Exhibit 3-5 *Amortization of Unrecognized Prior Service Cost*

Unrecognized prior service cost$_{T-1}$	$500,000
− Prior service cost arising from plan amendments during the current period	0
Amortization of prior service cost	−160,000
Unrecognized prior service$_T$	$340,000

T-1 = Beginning of year
T = End of year

Exhibit 3-4 Discussion. As of the measurement date for the beginning of the fiscal year in which SFAS 87 is first applied, an employer determines the transition amount. This transition amount is the difference as of the beginning of the adoption year between the projected benefit obligation and the fair value of plan assets adjusted for previously recognized accrued (prepaid) pension costs already on the firm's balance sheet. The amortization is on a straight-line basis over the average expected service life of employees expected to receive benefits under the plan. If the service life is less than 15 years, the pronouncement allows employers to use a 15-year period. The Company originally determined a transition amount of $165,000, of which $30,000 has been amortized over the last two years.

The prior service cost is the increase in the projected benefit obligations attributable to plan amendments, which increase benefits based on services rendered in prior periods. Prior service costs are amortized by assigning at the date of the amendment an equal amount to each service period of each active employee who is expected to receive benefits under the plan. This method resembles a declining balance method. Alternative amortizations (i.e., straight-line over the average remaining service period of employees expected to receive benefits under the plan) is permissible if the method will reduce deferred prior service cost more rapidly.

In the current reporting period, $160,000 of prior period service costs from earlier years' amendments is amortized. There are no new amendments in the current year, which can also be seen in Exhibit 3-1. Each new prior service cost increases the projected benefit obligations (that is, assuming that the benefit increases, as shown in Exhibit 3-1), and a separate amortization schedule would be established in the period in which the plan is amended.

16.5 Components of Pension Expense and Calculation of Provision

Exhibit 3-6 analyzes components of pension expense, while Exhibit 3-6A shows the calculation of that provision for the Company.

Exhibit 3-6 *Components of Pension Expense*

Service cost		$400,000
– Interest cost		456,250
– Expected return on assets:		
Actual return	450,000	
– Net gain (or loss) deferred during period	(210,000)	(240,000)
+ Amortization of:		
Unrecognized transition losses and (gains)	15,000	
Unrecognized prior service costs	160,000	
Unrecognized net (gains) and losses	13,750	188,750
Total pension costs		$805,000

Exhibit 3-6A *Components of Pension Costs and Their Income Statement Impact*

Component	*Exhibit*	*Income Statement Impact*
Service costs	2	Immediate recognition—debit
Interest cost	2	Immediate recognition—debit
Transition impact	4	Delayed recognition—debit if PBO exceeded plan assets as of implementation (credit if assets exceeded PBO).

Exhibit 3-6A (cont.)

Component	*Exhibit*	*Income Statement Impact*
Prior service cost	5	Delayed recognition—usually debit.
Expected return	3, 3A	Immediate recognition—credit (debit if expected loss). Expected return is actual return adjusted for the calculated portion of gains and losses deferred.
Unrecognized net (gains) and losses	7	Delayed recognition—debit if loss.

Exhibit 3-6 Discussion. Pension expense consists of service costs, interest costs, and expected returns (to the extent that expected return is a gain, there is a reduction in pension expense), all of which are immediately recognized. Transition impacts, prior service costs, and unrecognized net (gains) and losses all affect the income statement through a delayed recognition process. The amortization process for prior service costs and transitions amounts were previously discussed. Exhibits 3-7 and 3-8 develop the treatment of delayed gains and losses. The Company recognizes $805,000 in pension expense in 1988.

16.6 Unrecognized Gain and Loss and Corridor Method Amortization

Exhibit 3-7 analyzes the unrecognized gains and losses for the period, while Exhibit 3-8 provides the amortization of the unrecognized gains and losses using the corridor method.

Exhibit 3-7 *Unrecognized Net Gains or Losses*

Unrecognized net (gains) or losses$_{T-1}$	$662,500
+ Net asset (gain) or loss unrecognized during period	−210,000
+ Additional PBO (gains) and losses	+280,000
− Amortization (beginning period amount	−13,750
Unrecognized net (gains) or losses$_{T}$	$718,750

T-1 = Beginning of year
T = End of year
( ) = Credit

Exhibit 3-8 *Corridor Amortization*

Unrecognized net (gains) or losses$_{T-1}$	\$662,500
− Corridor (10% of greater of PBO$_{T-1}$ or market-related value plan assets$_{T-1}$)	−456,250
Excess above corridor	206,250
Amortization period	15 years
Amount amortized	\$ 13,750

- Additional current period PBO (gains) or losses and net asset gains or losses are deferred.
- Generally, under the corridor amortization method, these additional gains and losses do not enter into pension costs until the following year.
- The minimum to be amortized is the excess over the corridor.
- The corridor is 10 percent of the greater of pension benefit obligations or market-related values at the beginning of the period.
- The excess above the corridor, if any, is divided by the average remaining service period of active employees. (If almost all employees are inactive, life expectancy is used.)
- SFAS 87 does provide for alternative amortization methods if requirements are met.

T-1 = Beginning of year
T = End of year

Exhibit 3-7 and 3-8 Discussion. The difference between actual returns and expected returns (i.e., net asset (gain) or loss unrecognized during the period as in Exhibit 3-3A) is one component of unrecognized net (gains) or losses. Additionally, projected benefit obligations, as shown in Exhibit 3-2, can also increase or decrease due to changes in obligation-related assumptions as well as variances between actual and assumed experiences. These are referred to as additional PBO (gains) and losses. These unrecognized net gains and losses are amortized using the corridor method demonstrated in Exhibit 3-8. The Company uses this corridor amortization, although other systematic techniques are permitted under SFAS 87, if systematically followed.

Generally, the corridor method delays any recognition of current period additional gains and losses until the following period. The corridor is 10 percent of the greater of (a) projected benefit obligations as of the beginning of period or (b) market-related amounts as of the beginning of the period. The excess of unrecognized gains or losses as of the beginning of the period above that corridor is amortized using an average remaining service period of active employees. (If almost all employees are inactive, then life expectancy is used.) In Exhibit 3-8, a total of $13,750 is amortized and included as a component of pension expense.

16.7 Pension-Related Balance Sheet Values

Exhibit 3-9 provides pension-related balance sheet values, including amounts accrued before the minimum liability calculation at year end.

Exhibit 3-9 *Pension-Related Balance Sheet Values: Ending Balances*

Projected benefit obligation$_T$	(Exhibit 3-2)	$5,365,750
Plan assets at fair value$_T$	(Exhibit 3-3)	3,639,059
Funded status$_T$		1,726,691
Unrecognized net (asset)/obligation at transition$_T$	(Exhibit 3-4)	135,000
Unrecognized prior service cost$_T$	(Exhibit 3-5)	340,000
Unrecognized net (gain) or loss$_T$	(Exhibit 3-7)	718,750
(Accrued) or prepaid pension cost before additional minimum liability$_T$		$ (532,941)*

*The sum of additional current period accrued expenses totaling $282,941 and the amount of $250,000 on the books as of the beginning of the year.

T-1 = Beginning of year
T = End of year

Exhibit 3-9 Discussion. The key reconciling relationship is that funded status at the end of the period equals amounts not yet recognized on the books, plus accrued or prepaid amounts (before the minimum liability determination). Added together, the unrecognized transition amounts, unrecognized prior service costs, unrecognized net (gains) or losses, and the amounts accrued total $1,726,691.

16.8 Balance Sheet Summary

A final balance sheet summary is provided in Exhibit 3-10. This exhibit shows an additional minimum liability and corresponding intangible asset of $120,600. The derivation of the additional minimum liability is provided in Exhibit 3-11.

Exhibit 3-10 *Balance Sheet Summary*

(Accrued)/prepaid pension cost	($532,941)
Additional liability	(120,600)**
Intangible asset	120,600
Equity component	0

( ) = Credit

**Additional liability and intangible assets reduced by $79,400.

Exhibit 3-11 *Calculation of Minimum Additional Liability*

Accumulated benefit obligation$_T$	($4,292,600)
− Plan assets$_T$	3,639,059
Minimum liability$_T$	(653,541)
− (Accrued pension cost) or prepaid pension cost*	−(532,941)
Required additional liability	$ (120,600)

T = End of year
( ) = Credit

*Derived from Exhibit 3-9.

Exhibit 3-10 and 3-11 Discussion. The minimum liability on a company's books is the difference between the accumulated benefit obligations (projected benefit obligation without expected salary increments) and plan assets. In this case study, the minimum liability totals $653,541. A minimum additional liability of $120,600 is put on the balance sheet, since accrued amounts are only $532,941. Since there are sufficient unrecognized prior service costs, the Company recognizes an intangible asset equal to the additional minimum liability of $120,600.

16.9 Sample Footnotes and Journal Entries

The sample footnotes and journal entries are as follows.

Exhibit 3-12 *Note on Pensions*

Empwel has a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation during the last five years of employment. Empwel's funding policy is to contribute annually an amount at a rate to maintain a level percentage of compensation for covered employees. Contributions are intended to provide not only for benefits attributed to service to date, but also for benefits expected to be earned in the future.

Exhibit 3-12 (cont.)

The following table sets forth the plan's funded status and amounts recognized in Empwel's statement of financial position at December 31, 19X8.

Empwel

	12/31/X8
Reconciliation:	
Vested benefit obligation	$(2,897,505)
plus nonvested accumulated benefits	(1,395,095)
Accumulated benefit obligation	(4,292,600)
plus effect of projected increases	(1,073,150)
Projected benefit obligation	(5,365,750)
Plan assets (fair value)	3,639,059
Funded status	(1,726,691)
Deferred transition loss	135,000
Prior service cost	340,000
Unrecognized loss	718,750
Additional liability	(120,600)
Net pension liability on statement of financial position	$ (653,541)
Pension Expense:	
Service cost	$ 400,000
Interest expense	456,250
Actual return on plan assets	(450,000)
All other components	398,750
Total	$ 805,000

Journal Entries:

Pension expenses	$805,000	
Cash		$522,059
Accrued expense		282,941
•Additional liability	79,400	
Intangible asset		79,400

•Reduces the beginning-of-the-period additional minimum liability from $250,000 to the end-of-the-period balance of $120,600.

The weighted-average discount rate and rate of increase in future compensation levels used to determine the actuarial present value of the projected benefit obligations were 10 percent and 6 percent respectively. The expected long-term rate of return on assets is 8 percent.

APPENDIX A

Comparison of SFAS 87 with Previous Standards for Single Employer Defined Benefit Pension Plans

	APB 8 As Amended	*SFAS 87*
Periodic pension cost: Attribution method (method used to calculate service cost)	Any "acceptable actuarial cost method."	Based on terms of the plan (usually equivalent to projected unit credit method).
Recognition of cost of retroactive amendments (prior service cost)	In practice, delayed; APB 8 allows no recognition in certain circumstances.	Delayed.
Amortization of unrecognized prior service cost: Method	If amortized, should be systematic and rational; in practice, "interest method"* predominates.	Assignment of equal amounts to each future period of service of each employee active at amendment date and expected to receive benefits under the plan. Simpler alternative available if it more rapidly reduces unamortized balances.
Period or rate	Opinion specifies minimum and maximum; maximum, including interest, is 10 percent of original balance.	Period relates to remaining service of closed group.
Recognition of gains and losses	Delayed, first through use of various asset valuation methods and then by amortization; no disclosure.	Delayed; disclosure required.

	APB 8 As Amended	*SFAS 87*
Amortization of unrecognized gains and losses: Method	Variety of methods allowed.	Any system that is consistently applied; subject to a minimum based on "corridor" method.
Period or rate	If spreading is accomplished separately, 10, 50, 20 years suggested as the period.	Minimum rate equal to one divided by average remaining service period; applied only to amount outside the corridor.
Selection of assumptions	Not addressed, but in practice both explicit and implicit assumptions are used.	Explicit.
Liabilities and assets: Recognition of liabilities for unfunded accrued pension cost	Required.	Required.
Recognition of assets for prepaid pension cost	Required.	Required.
Recognition of additional liability	If the employer has legal obligation for pension cost, is excess of amounts paid or accrued; in practice, however, it's rare.	If unfunded, accumulated benefit obligation exceeds unfunded accrued pension cost.
Recognition of other elements when liability is required	Deferred charge.	Intangible asset to the extent of unamortized prior service cost;** reduction of equity for any excess.

*The "interest method" of amortization allocates prior service cost so that the total of that cost and interest on the unrecognized (or unfunded) balance is the same for each period. Under that method, the smallest amounts of prior service cost are recognized in the years immediately after an amendment, when interest on the unamortized balance is highest.

**Includes unrecognized net obligation at the date of initial application.

APPENDIX B

Amortization of Unrecognized Prior Service Cost

Case 1. Assigning equal amounts to future years of service

Determination of expected future years of service

The amortization of unrecognized prior service cost defined in paragraph 25 is based on the expected future years of service of participants active at the date of the amendment who are expected to receive benefits under the plan. Calculation of the expected future years of service considers population decrements based on the actuarial assumptions and is not weighted for benefits or compensation. Each expected future service year is assigned an equal share of the initially determined prior service cost. The portion of prior service cost to be recognized in each of the future year is determined by the service years rendered in that year.

The following chart illustrates the calculation of the expected future years of service for the defined benefit plan of Company E. At the date of the amendment (January 1, 1987), the company has 100 employees who are expected to receive benefits under the plan. Five percent of that group (5 employees) are expected to leave (either retire or quit) in each of the next 20 years. Employees hired after that date do not affect the amortization. Initial estimates of expected future years of service related to each amendment are subsequently adjusted only for a curtailment.

Determination of Expected Years of Service
Service Years Rendered in Each Year

	Future	*Year*																			
Individuals	*Service Years*	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*16*	*17*	*18*	*19*	*20*
A1-A5	5	5																			
B1-B5	10	5	5																		
C1-C5	15	5	5	5																	
D1-D5	20	5	5	5	5																
E1-E5	25	5	5	5	5	5															
F1-F5	30	5	5	5	5	5	5														
G1-G5	35	5	5	5	5	5	5	5													
H1-H5	40	5	5	5	5	5	5	5	5												
I1-I5	45	5	5	5	5	5	5	5	5	5											
J1-J5	50	5	5	5	5	5	5	5	5	5	5										
K1-K5	55	5	5	5	5	5	5	5	5	5	5	5									
L1-L5	60	5	5	5	5	5	5	5	5	5	5	5	5								
M1-M5	65	5	5	5	5	5	5	5	5	5	5	5	5	5							
N1-N5	70	5	5	5	5	5	5	5	5	5	5	5	5	5	5						
O1-O5	75	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5					
P1-P5	80	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5				
Q1-Q5	85	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5			
R1-R5	90	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5		
S1-S5	95	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	
T1-T5	100	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
	1,050																				
Service Years Rendered		100	95	90	85	80	75	70	65	60	55	50	45	40	35	30	25	20	15	10	5
Amortization Fraction		$\frac{100}{1,050}$	$\frac{95}{1,050}$	$\frac{90}{1,050}$	$\frac{85}{1,050}$	$\frac{80}{1,050}$	$\frac{75}{1,050}$	$\frac{70}{1,050}$	$\frac{65}{1,050}$	$\frac{60}{1,050}$	$\frac{55}{1,050}$	$\frac{50}{1,050}$	$\frac{45}{1,050}$	$\frac{40}{1,050}$	$\frac{35}{1,050}$	$\frac{30}{1,050}$	$\frac{25}{1,050}$	$\frac{20}{1,050}$	$\frac{15}{1,050}$	$\frac{10}{1,050}$	$\frac{5}{1,050}$

On January 1, 1987, Company E granted retroactive credit for prior service pursuant to a plan amendment. This amendment generated unrecognized prior service cost of $750,000. The amortization of the unrecognized prior service cost resulting from the plan amendment is based on the expected future years of service of active participants as discussed in the previous paragraph.

Amortization of Unrecognized Prior Service Cost

Year	*Beginning-of-Year Balance*	*Amortization Rate*	*Amortization*	*End-of-Year Balance*
1987	750,000	100/1050	71,429	678,571
1988	678,571	95/1050	67,857	610,714
1989	610,714	90/1050	64,286	546,428
1990	546,428	85/1050	60,714	485,714
1991	485,714	80/1050	57,143	428,571
1992	428,571	75/1050	53,571	375,000
1993	375,000	70/1050	50,000	325,000
1994	325,000	65/1050	46,429	278,571
1995	278,571	60/1050	42,857	235,714
1996	235,714	55/1050	39,286	196,428
1997	196,428	50/1050	35,714	160,714
1998	160,714	45/1050	32,143	128,571
1999	128,571	40/1050	28,571	100,000
2000	100,000	35/1050	25,000	75,000
2001	75,000	30/1050	21,429	53,571
2002	53,571	25/1050	17,857	35,714
2003	35,714	20/1050	14,286	21,428
2004	21,428	15/1050	10,714	10,714
2005	10,714	10/1050	7,143	3,571
2006	3,571	5/1050	3,571	0

Case 2. Using straight-line amortization over average remaining service period

Determination of expected future years of service

To reduce the complexity and detail of the computations shown in Illustration 3, Case 1, alternative amortization approaches that recognize the cost of retroactive amendments more quickly may be consistently used (paragraph 26). For example, a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan is acceptable.

If Company E (Case 1) had elected to use straight-line amortization over the average remaining service period of employees expected to receive benefits (1,050 future service years/100 employees = 10.5 years), the amortization would have been as follows:

Amortization of Unrecognized Prior Service Cost

Year	*Beginning-of-Year Balance*	*Amortization*[a]	*End-of-Year Balance*
1987	750,000	71,429	678,571
1988	678,571	71,429	607,142
1989	607,142	71,429	535,713
1990	535,713	71,429	464,284
1991	464,284	71,429	392,855
1992	392,855	71,429	321,426
1993	321,426	71,429	249,997
1994	249,997	71,429	178,568
1995	178,568	71,429	107,139
1996	107,139	71,429	35,710
1997	35,710	35,710	0

[a]750,000/10.5 = 71,429.

APPENDIX C

Financial Statements and Notes Checklist for Pension Costs

Following are selected questions pertinent to Statement of Financial Accounting Standards No. 87. These items are extracted from the AICPA *Auditing and Accounting Manual,* Section 8400, "Disclosure Checklists for Corporations." These items are not all-inclusive and are not intended to present minimum requirements.

	Yes	No	N/A
Pension Plans			
1. If there is a defined benefit plan, do disclosures include:			
a. A description of the plan including employee groups covered, type of benefit formula, funding policy, types of assets held and significant nonbenefit liabilities, if any, and the nature and effect of significant matters affecting comparability of information for all periods presented?	—	—	—
b. The amount of net periodic pension cost for the period showing separately the service cost component, the interest cost component, the actual return on assets for the period, and the net total of other components?[1]	—	—	—
c. A schedule reconciling the funded status of the plan with amounts reported in the employer's statement of financial position, showing separately:			
(1) The fair value of assets?	—	—	—
(2) The projected benefit obligation identifying the accumulated benefit obligation and the vested benefit obligation?	—	—	—
(3) The amount of unrecognized prior service cost?	—	—	—
(4) The amount of unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)?	—	—	—
(5) The amount of any remaining unrecognized net obligation or net asset existing at the date of initial application of SFAS 87[AC P16]?	—	—	—
(6) The amount of any additional liability recognized pursuant to SFAS 87, paragraph 36 [AC P16.130]?	—	—	—
(7) The amount of net pension asset or liability recognized in the statement of financial posi-			

Yes *No* *N/A*

tion pursuant to SFAS 87, paragraphs 35-36 [AC P16.129-.130] (which is the net result of combining the preceding six items)? ___ ___ ___

d. The weighted-average assumed discount rate and rate of compensation increase (if applicable) used to measure the projected benefit obligation and the weighted-average expected long-term rate of return on plan assets? ___ ___ ___

e. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of annual benefits of employees and retirees covered by annuity contracts issued by the employer and related parties? Also, if applicable, the alternative amortization methods used pursuant to SFAS 87, paragraphs 26 and 33 [AC P16.120 and .127], and the existence and nature of the commitment discussed in paragraph 41 [AC P16.135]? ___ ___ ___

f. If more than one defined benefit plan exists:

(1) Have the disclosures requires by 1 above been aggregated for all of the employee's single-employer defined benefit plans or disaggregated in groups so as to provide the most useful information? ___ ___ ___

(2) Are plans with assets in excess of accumulated benefit obliglations not aggregated with plans that have accumulated benefit obligations that exceed plan assets? ___ ___ ___

(3) Are disclosures for plans outside the U.S. not combined with those for U.S. plans unless those plans are similar economic assumptions? ___ ___ ___

[SFAS 87, par. 56 (AC P16.153)]

2. If there is a defined contribution plan, do disclosures include:

a. A description of the plan(s), including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability of information for all periods presented? ___ ___ ___

b. The amount of cost recognized during the period? ___ ___ ___

[SFAS 87, par. 65 (AC P16.162)]

	Yes	No	N/A
c. If the pension plan has characteristics of both a defined benefit plan and a defined contribution plan:			
(1) Is the substance of the plan to provide a defined benefit?	—	—	—
(2) If answer is yes, are accounting and disclosure requirements in accordance with the provisions of L1 above, applicable to a defined benefit plan?	—	—	—
[SFAS 87, par. 66 (AC P16.163)]			
3. If there is a multiemployer plan, do disclosures include:			
a. A description of the multiemployer plan(s) including the employee groups covered, the type of benefits provided (defined benefit or defined contribution), and the nature and effect of significant matters affecting comparability of information for all periods presented?	—	—	—
b. The amount of cost recognized during the period?	—	—	—
[SFAS 87, par. 69 (AC P16.166)]			
c. If the situation arises where the withdrawal from a multiemployer plan may result in the employer having an obligation to the plan for a portion of its unfunded benefit obligations which is either probable or reasonably possible, have the provisions of SFAS 5 [AC C59] been applied?	—	—	—
[SFAS 87, par. 70 (AC P16.167)]			
4. If there is a settlement and/or curtailment of a defined benefit pension plan and/or termination benefits under such plan, do disclosures include:			
a. A description of the nature of the event(s)?	—	—	—
b. The amount of gain or loss recognized?	—	—	—
[SFAS 88, par. 17 (AC P16.187)]			
5. Has an asset (prepaid pension cost) been recognized if net periodic pension cost is less than amounts the employer has contributed to the plan?	—	—	—
[SFAS 87,pars. 35 & 38 (AC P16.129 and .132)]			
6. If an additional minimum liability has been recognized pursuant to SFAS 87, paragraph 36 [AC P16.130], has an equal amount been recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost?	—	—	—
[SFAS 87, pars. 37-38 (AC P16.131-.132)]			

	Yes	No	N/A
7. Has a liability (unfunded accrued pension cost) been recognized if net periodic pension cost recognized, pursuant to SFAS 87 [AC P16], exceeds amounts the employer has contributed to the plan? [SFAS 87, pars. 35 & 38 (AC P16.129 and .132)]	—	—	—
8. If the accumulated benefit obligation exceeds the fair value of the pension plan's assets, has the employer recognized, in the statement of financial position, a liability (including unfunded accrued pension cost) that is at least equal to the unfunded accumulated benefit obligation? [SFAS 87, pars. 36 & 38 (AC P16.130 and .132)]	—	—	—
9. Has an additional minimum liability been recognized in accordance with the provisions of SFAS 87, paragraph 36? [SFAS 87, pars. 36 & 38 (AC P16.130 and .132)]	—	—	—
10. If an additional liability required to be recognized pursuant to SFAS 87, paragraph 36 [AC P16.130], exceeds unrecognized prior service cost, has the excess (which would represent a net loss not yet recognized as net periodic pension cost) been reported as a separate component (that is a reduction) of equity, net of any tax benefits that result from considering such losses as timing differences for purposes of applying the provisions of APB 11? [SFAS 87, par. 37 (AC P16.131)]	—	—	—
11. Is the cost of the pension plan(s) accounted for in conformity with SFAS 87,[2] paragraphs 20-34, 39-53, and 77? (See Exhibit A) [SFAS 87, pars. 20-34, 39-53 & 77 (AC P16.114-.128, .133-.138 and .141-.149)]	—	—	—
12. Have settlements of defined benefit pension plans been accounted for in accordance with SFAS 88, paragraphs 3-5 and 9-11? [SFAS 88, pars. 3-5 & 9-11 (AC P16.172, .177-.179 and .181)]	—	—	—
13. Have curtailments of defined benefit pension plans been accounted for in accordance with SFAS 88, paragraphs 6 and 12-14? [SFAS 88, pars. 6 & 12-14 (AC P16.173 and .182-.184)]	—	—	—

	Yes	No	N/A
a. Have such settlements and curtailments been properly differentiated in accordance with SFAS 88, paragraphs 7-8? [SFAS 88, pars. 7-8 (AC P16.174-.175)]	—	—	—
14. Have termination benefits been accounted for in accordance with SFAS 88, paragraph 15? [SFAS 88, par. 15 (AC P16.185)]	—	—	—
15. Has the gain or loss measured in accordance with SFAS 88, paragraphs 9-10, 12-13 or 15, which is directly related to a disposal of a segment of a business, been included in determining the gain or loss associated with that event, and recognized in accordance with APB 30? [SFAS 88, pars. 9-10, 12-13 & 15 (AC P16.177, .179, .182-.183 and .185)]	—	—	—

[1]The net total of other components is the net effect during the period of certain delayed recognition provisions of this statement. That net total includes:

a. The net asset gain or loss during the period deferred for later recognition (in effect, an offset or a supplement to the actual return on assets).
b. Amortization of the net gain or loss from earlier periods.
c. Amortization of unrecognized prior service cost.
d. Amortization of the unrecognized net obligation or net asset existing at the date of initial application of SFAS 87 [AC P16].

[2]Accounting for defined contribution plans and for multiemployer plans is generally the same as current practice. The new pension rules apply primarily to companies offering defined benefit pension plans.

CHAPTER 4

Accounting for Consolidations

(FASB Statement No. 94)

CHAPTER 4
Accounting for Consolidations
(FASB Statement No. 94)

1. INTRODUCTION

Issued in October 1987 by the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 94, entitled *Consolidation of All Majority-Owned Subsidiaries*, is part of a larger reconsideration of consolidation, including an examination of the concept of the "reporting entity" and the element of control instead of majority ownership as the basis for consolidation. Under a revised concept of control, consolidation might very well be required for cases involving significant minority ownership, if the majority ownership is widely dispersed.

The Board's tentative conclusions on the concept of a reporting entity for business enterprises are not yet ready to be issued. However, the Board's deliberations have proceeded far enough for it to conclude that consolidation of all majority-owned subsidiaries for which control is not in question is consistent with all of the reporting entity concepts now under consideration by the Board.

2. CONSOLIDATION OF MAJORITY-OWNED SUBSIDIARIES

SFAS 94 amends the following pronouncements:

- Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*
- Accounting Principles Board (APB) Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*
- ARB 43, Chapter 12, *Foreign Operations and Foreign Exchange*

SFAS 94 requires consolidation of *all* majority-owned subsidiaries. The Statement eliminates such previous exceptions as nonconsolidation because of (a) nonhomogeneous operations, typically finance, insurance, real estate, and leasing subsidiaries of manufacturing and merchandising enterprises; (b) large minority interests (though this is rare); and (c) other restrictive policies, such as consolidating only wholly owned subsidiaries.

The Statement also narrows the exceptions for consolidation of majority-owned foreign subsidiaries by effectively eliminating the distinction between foreign and domestic subsidiaries.

Further, SFAS 94 continues ARB 51's proscription of consolidation in cases where the control is likely to be temporary or if it does not rest with the majority (for instance, if the subsidiary is in legal reorganization or in bankruptcy, or it operates under foreign exchange restrictions, controls, or other government-imposed uncertainties that cast doubt on the parent's ability to control the subsidiary).

3. CONTINUED DISCLOSURE ON PREVIOUSLY UNCONSOLIDATED SUBSIDIARIES

SFAS 94 specifies that information that was disclosed under APB 18 about majority-owned subsidiaries that were unconsolidated in financial statements for fiscal years 1986 or 1987 should continue to be disclosed for them even after they are consolidated. (Disclosure may take the form of summarized information about assets, liabilities, and the results of operations, or separate statements.) The Board reached this conclusion because of the overriding need to prevent the loss of important information; users of financial statements urged the Board to retain this information while deliberating the broader "reporting entity" project.

4. PRECLUDES PARENT-COMPANY STATEMENTS AS PRIMARY

APB 18 is amended to eliminate (a) its requirement to use the equity method in consolidated statements to account for unconsolidated majority-owned subsidiaries and (b) its provisions applying to the preparation of "parent-company" financial statements issued to stockholders as the financial statements of the primary reporting entity, a practice now precluded by SFAS 94.

5. EQUITY METHOD APPLICABLE: "SIGNIFICANCE INFLUENCE"

Note that the equity method would still be applicable if a majority-owned subsidiary is not consolidated in accordance with SFAS 94, but "significant influence" remains even though control is lost.

6. EFFECTIVE DATE

SFAS 94 is effective for financial statements for fiscal years ending after December 15, 1988. Earlier application is encouraged. Restatement of comparative financial statements for earlier years is required.

7. APPLICATION

The 1988 edition of *Accounting Trends and Techniques*, which includes the study of 600 corporate reports with fiscal years ending January 31, 1988, reveals that 13 companies chose early adoption of SFAS 94.

In the footnotes to its 1987 annual report, Aluminum Company of America (Alcoa) disclosed that effective December 31, 1987, the company "revised its consolidation accounting policy to conform to the Financial Accounting Standard Board's (FASB) newly issued Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*. Prior to the change, Alcoa had consolidated only wholly owned subsidiaries (except Alcoa Properties, Inc.). All prior year data included in this report has been restated to conform to the change. See Note T for additional information regarding the subsidiaries that are now being consolidated."

Further, in accordance with the requirement for continued disclosure of the earnings and assets of previously unconsolidated subsidiaries, Alcoa disclosed the following regarding its majority-owned subsidiaries (see Exhibit 4-1):

Exhibit 4-1 *Aluminum Company of America,*
Annual Report, 12/31/87
T. Majority-owned Subsidiaries

Following are the condensed financial statements of the majority-owned subsidiaries that are now being consolidated to conform to the accounting change described in Note B.

Alcoa Aluminio S.A. (Aluminio). Summarized consolidated financial data for Alumino, a 64%-owned Brazilian subsidiary (62 and 61% in 1986 and 1985, respectively), follows.

December 31	*1987*	*1986*
Current assets	$ 219.3	$ 146.7
Properties, plants and equipment, net	932.4	932.1
Other assets	81.3	92.4
Total assets	1,233.0	1,171.2
Current liabilities	178.4	109.7
Long-term debt	505.5	566.8
Other liabilities	27.5	21.1
Total liabilities	711.4	697.6
Net assets	$ 521.6	$ 473.6

	1987	*1986*	*1985*
Revenues	$ 625.9	$ 418.3	$ 335.4
Costs and expenses	532.3	419.7	360.5
Foreign currency (losses)	(25.9)	(10.5)	(10.8)
Income tax expense (benefit)	1.3	—	(1.8)
Net income (loss)	$ 66.4	$ (11.9)	$ (34.1)

Alcoa of Australia Limited (AA). Summarized consolidated financial data for AA, a 51%-owned subsidiary, follows.

December 31	*1987*	*1986*
Current assets	$ 301.3	$ 252.5
Properties, plants and equipment, net	1,498.6	1,464.0
Other assets	230.8	205.3
Total assets	2,030.7	1,921.8
Current liabilities	276.5	199.1
Long-term debt	473.0	571.1
Other liabilities	286.9	237.1
Total liabilities	1,036.4	1,007.3
Net assets	$ 994.3	$ 914.5

Exhibit 4-1 (cont.)

	1987	1986	1985
Revenues*	$ 1,028.0	$ 761.7	$ 858.1
Costs and expenses	752.4	650.5	736.2
Foreign currency (losses)	(89.9)	(42.5)	(10.0)
Income tax expense	106.0	30.0	49.0
Net income (loss)	$ 79.7	$ 38.7	$ 62.9

*Revenues from wholly-owned subsidiaries of Alcoa were $85.0 in 1987, $80.5 in 1986 and $111.6 in 1985. The terms of the transactions were established by negotiation between the parties.

Other Majority-owned Subsidiaries and Entities. Summarized financial data for Alcoa's other majority-owned subsidiaries and entities not previously consolidated follows.

December 31	1987	1986
Current assets	$388.5	$384.9
Properties, plants and equipment, net	381.1	337.0
Other assets	205.9	240.0
Total assets	975.5	961.9
Current liabilities	205.5	214.1
Long-term debt	39.7	59.2
Other liabilities	98.8	86.1
Total liabilities	344.0	359.4
Net assets	$631.5	$602.5

	1987	1986	1985
Revenues	$896.4	$1,012.7*	$591.0
Costs and expenses	824.0	715.1	542.0
Income tax expense	23.9	42.1	14.1
Net income (loss)	$ 48.5	$ 255.5	$ 34.9

*Includes a $221.1 gain from a real estate sale

In its 1987 annual report, Pfizer, Inc. disclosed that "the consolidated financial statements include the accounts of Pfizer, Inc. and all significant subsidiaries. Material intercompany transactions are eliminated."

In addition, that report disclosed the following:

> In 1987, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 94, "Consolidation of All Majority-owned Subsidiaries." By implementing this accounting standard, the finan-

> cial operations of its wholly owned, offshore banking subsidiary, as well as a small captive offshore insurance company, are consolidated. These companies were previously presented as unconsolidated subsidiaries accounted for under the equity method of accounting. Prior year financial statements have been restated to reflect this change.

SFAS 94 does not prescribe any format for the presentation of nonhomogeneous operations for which line-by-line integration of assets, liabilities, revenues, and expenses is neither possible or meaningful. If the amounts are material, the most likely format will be either a separate columnar presentation of the various operations, culminating in a single consolidated total column, or horizontal segmentation of the balance sheet and income statement.

CHAPTER 5

Accounting for Loan Origination Fees

(FASB Statement No. 91 and a Guide to Implementation of Statement No. 91)

CHAPTER 5

Accounting for Loan Origination Fees

(FASB Statement No. 91 and a Guide to Implementation of Statement No. 91)

1. INTRODUCTION

Issued in December 1986, by the Financial Accounting Standards Board (FASB), SFAS 91, entitled *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*, specifies the accounting for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans. For purposes of this Statement, lending activities include—

- Lending
- Committing to lend
- Refinancing or restructuring loans
- Arranging stand-by letters of credit
- Syndicating loans
- Leasing activities

Even if lending activities and loan purchases do not involve fees, SFAS 91 still applies; while some loans and leases may not have fees, they may have costs associated with their origination.

The provisions of SFAS 91 apply to all types of loans, including debt securities, as well as to all types of lenders, including banks, thrift institutions, insurance companies, mortgage bankers, and other financial and nonfinancial institutions. The Statement specifies the accounting for fees and initial direct costs associated with leasing. Interest and principal-only securities represent interests in loans and, therefore, are subject to the provisions of SFAS 91.

The Statement does not apply to loan origination fees that are refundable but is applicable if such fees subsequently become nonrefundable. SFAS 91 does not apply to nonrefundable fees and costs associated with originating loans reported at market value or to premiums and discounts associated with acquiring loans reported at market value. Loans that are reported at cost or lower of cost or market as well as loans that have a market rate of interest are not considered to be carried at market value. Those loans held in trading accounts by certain financial institutions and carried at market value are not subject to the Statement. However, loans that are held in investment portfolios and carried at historical or amortized costs, as well as those held for resale and carried at lower of cost or market, are subject to SFAS 91.

2. ORIGINATION FEES AND LOAN ORIGINATION COSTS

2.1 Origination Fees

Origination fees are fees charged to the borrower in connection with originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction. Origination fees also include syndication and participation fees to the extent to which they are associated with the portion of the loan retained by the lender.

2.2 Direct Loan Origination Costs of a Completed Loan

Direct loan origination costs include only certain costs directly related to specified activities performed by the lender and to incremental direct costs of loan origination that are incurred in transactions with independent third parties.

Examples of originating activities for which internally incurred lender costs are accumulated include:

- Evaluating the prospective borrower's financial condition.
- Evaluating and recording guarantees, collateral, and other security arrangements.
- Negotiating loan terms.
- Preparing and processing loan documents.
- Closing the transaction.

Additional examples of originating activities are loan counseling, application processing, appraisal, initial credit analysis, initial credit investigation, quality control review during underwriting, direct approval processing, origination responsibilities of loan evaluation and approval committees, and loan closing.

For successful origination of loans, the lender accumulates that portion of the employees' total compensation and payroll-related fringe benefits which is directly related to time spent on those internally performed activities defined above. Executive salaries and benefits are part of loan origination costs. Payroll-related fringe benefits include payroll taxes, dental and medical insurance, group life insurance, retirement plans, 401 (k) plans, stock compensation plans, and overtime meal allowances. Bonuses and commissions for the successful production of loans are considered to be part of total compensation, and the portion attributable to the originating activities is traced to the successful loan. Even if employees are paid solely on a commission basis, allocations must be made between origination and other activities.

Standard costing or actual costing systems may be used to trace costs to successful loan origination activities. Individual loans that are unique by nature may entail a job order system. Homogeneous loans may permit the implementation of a process system. If a standard costing system is used, variances must be analyzed and standard rates periodically reviewed. Successful loan efforts can be determined as a percentage of each of the following functions: application, verification, underwriting, appraisal, and closing. This percentage-by-function should be adjusted both for idle time and for time spent on activities not considered loan origination. Measuring successful loan efforts on a firm-wide basis is inappropriate in determining the amount of loan origination costs as defined under SFAS 91.

Idle time caused by such factors as lack of work, delays, and equipment failure are to be expensed as incurred. Standard costs, time studies, and ratios of productive and nonproductive time are among those methods permitted to measure idle time.

In addition, certain other costs that are related to loan origination activities performed by the lender are accumulated and traced to successful originations. These costs include reimbursement of travel-related expenditures for loan origination activities; costs of itemized phone bills related to underwriting; and reimbursement for mileage and tolls involved in on-site reviews of collateral. However, a lender's data-processing equipment and software dedicated to loan origination do not qualify.

If loan origination services are performed by an independent third party, the incremental direct costs identifiable with loan origination are accumulated and traced to successful loan originations. Independent third parties are not employees and, therefore, do not receive employee benefits from the lender; they are not under the control of the lender as defined by FASB Statement of Financial Accounting Standards No. 57 (SFAS 57), *Related Party Disclosures*, and they generally provide similar services to other entities.

2.3 Incremental Direct Costs of Services Rendered by Independent Third Parties

Incremental direct service costs consist of loan origination costs that (a) result directly from, and are essential to, the lending transaction and (b) would not have been incurred if the lending transaction had not occurred. Such costs might include fees paid to independent property appraisers and to outside attorneys for preparation of loan documents.

2.4 Accounting and Reporting for Loan Origination Fees and Costs

Loan origination fees are deferred and recognized over the life of the loan as an adjustment to yield (interest income). Direct loan origination costs are deferred and recognized as a reduction in the yield of the loan. All other lending-related costs for such activities as advertising, soliciting potential borrowers, servicing existing loans, establishing and monitoring credit policies, and supervision and administration are expensed as incurred. Employees' compensation and fringe benefits for these activities as well as for unsuccessful loan origination activities, idle time, administrative costs, rent, depreciation, occupancy, and equipment are expensed as incurred.

Loan origination fees and the related direct loan origination costs are offset, and the net amount is recognized as an adjustment of yield. SFAS 91 no longer permits expensing loan origination costs and then recognizing an equal amount of loan origination fees in income.

The above accounting for loan origination fees is modified when a troubled debt restructuring exists, as defined by FASB Statement of Financial Accounting Standards No. 15 (SFAS 15), *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. If there is a modification of terms of a troubled debt restructuring, the fees that are received will reduce the recorded investment in the loan. Direct loan origination costs and all other costs are charged to expense as incurred.

Case 1 illustrates treatment of lending fees and costs under SFAS 91.

Case 1. Instant Banking Corp. loan origination activities

Facts

Advertising and solicitation	$ 280
Computer costs for origination activities	300
Salaries and fringe benefits for successful loan origination activities	400
Salaries and fringe benefits for unsuccessful loan origination activities	200
Incremental direct costs to independent third parties	350
Identifiable indirect origination costs incurred by lender	70
Advisory fee regarding origination activities to independent third party	500
Net origination fee for $80,000 loan	$3,000

The accounting treatment for origination activities related to new loans is as follows.

Solution. Based on the requirements of SFAS 91, the following items are treated as expenses of the current period:

Advertising and solicitation	$ 280
Computer costs for origination activities	300
Salaries and fringe benefits for unsuccessful loan origination activities	200
Identifiable indirect origination costs incurred by lender	70
Advisory fee for origination activities paid to independent third party	500
	$1,350
Net deferred origination fees: $3,000 − 750	$2,250

Only costs for successful loan origination activities are deferred and netted against origination fees. Advisory services for loan origination activities, whether paid to independent third parties or performed internally, are not specified loan origination activities. The $2,250 becomes an adjustment to yield, which is illustrated later in this chapter.

3. COMMITMENT FEES AND COSTS

3.1 Commitment Fees

Commitment fees are charged for entering into an agreement that obligates an enterprise to make or acquire a loan, or to satisfy an obligation of the other party under a specified condition. For purposes of SFAS 91, commitment fees include fees for letters of credit as well as for obligations to purchase a loan or group of loans, and pass-through certificates.

3.2 Accounting and Reporting

Except for two specific types of commitments, such fees are deferred and, if the loan is made, recognized as income over the life of the loan through an adjustment to yield. If such loan commitments expire unexercised, fee income is recognized upon expiration. Direct loan origination costs incurred for making such commitments are offset against the commitment fee, and the net amount is recognized as specified above. Origination costs on a loan in process may be deferred until the loan is closed or declared unsuccessful. In determining loans designated as unsuccessful, information obtained after the balance-sheet date, but before the report-issuance date, can be used.

The first exception occurs if a company's prior experience with similar types of financial arrangements suggests the likelihood of the commitment actually being exercised is remote, then the commitment fee income is recognized over the commitment period. A straight-line basis is used, and the income reported is designated as service-fee income. For those "remote" loans exercised during the commitment period, the unamortized balance is deferred and recognized using a yield adjustment. If the likelihood of exercise is remote, and such qualifying costs (for example, direct loan origination costs) associated with these commitments exceed commitment fees received (or no fee is charged), net costs are immediately charged to expense rather than deferred and amortized on a straight-line basis over the commitment period.

The second exception involves arrangements in which the commitment fees are based on a line of credit that is available, but unused, from a previous period. Under this situation, fee income is recognized at the determination date, provided that: (a) the percentage fee charged for the commitment is nominal compared to the stated rate on related borrowings and (b) such related borrowings are at a market interest rate.

If a commitment fee is determined retrospectively and direct loan origination costs are incurred when the lender establishes the commitment, the costs should be deferred and amortized over the commitment period, unless the likelihood of commitment is remote; in that case, any net costs are charged to expense. If the above commitment agreement is for a revolving line of credit, net costs are amortized using a straight-line basis over the period for which the revolving credit is active.

Case 2 illustrates the treatment of remote and retrospective commitment fees and costs under SFAS 91.

Case 2. Instant Banking Corp. commitment fees

Facts. On February 1, 1988, Instant Banking Corp. enters into a 15-month commitment to lend Nabico $2,000,000 for four years at 12 percent. A $42,500 commitment fee is received, and direct origination costs of $5,000 are paid. The loan is designated as remote. On January 1, 1989, the loan is exercised. Additionally, Nabico has an $8,000,000 line of credit, of which an average of $6,000,000 remains unused over the 1988 fiscal period. An annual 2-percent service fee is charged on the average unused line of credit.

Solution. Consistent with SFAS 91, the 1988 service-fee income is $27,500 (11 × $2500 per month) on the loan designated as remote. A service fee income of $120,000 is recognized on the line of credit, which is determined on a retrospective basis at the end of the year.

In 1989, the remaining unamortized net costs totaling $10,000 will be deferred and spread over the four-year loan period, using the interest method.

4. CREDIT CARD FEES AND COSTS

4.1 Credit Card Fees

Credit card fees are the periodic uniform fees that entitle cardholders to use credit cards. For purposes of this Statement, the term credit card fees includes fees that are received in such arrangements as charge card and cash fees.

4.2 Accounting and Reporting

Credit card fees are deferred and recognized on a straight-line basis over the period in which the fee entitles credit card use. Costs of credit card origination, determined in the same way as direct loan origination costs, are eligible for deferral and amortized over the period of credit card use. All other costs are charged to expense as incurred. If a lender for a fee engages an independent third party to solicit new cardholders, all such fees paid to third parties, including the portion allocable to successful efforts, are expensed since the fee is not considered to be an incremental direct cost to originate a loan. In this example, the lender would have incurred all costs, regardless of the number of credit cards issued.

5. SYNDICATION FEES

5.1 Accounting and Reporting

Loan syndication fees are recognized when the syndication is completed. If a syndicator retains a portion of the loan and receives an average yield below that of other participants, a portion of the loan syndication fees is deferred to increase a syndicator's average loan yield to that of other participants. If the retained portion has a yield equal or greater to that of other participants, such syndication fees should be recognized when the syndication is completed, using the same method of accounting employed by the lender for those fees prior to SFAS 91.

When an originating lender sells *participations* (as distinguished from *syndications*) in loans, the deferred net fees and costs become a component of the net loan investment balance and are used to calculate gains and losses on subsequent sales.

Case 3 illustrates recognition of loan syndication fees.

Case 3. Instant Banking Corp. syndication activities

Facts. Instant Banking Corp. is managing a $5,000,000 syndication and will receive 50 percent of the $200,000 syndication fee. Instant Banking Corporation retains 20 percent of a loan bearing a 10-percent interest rate, which is repayable in four equal installments. The weighted average effective loan yield on the portion held by other participants is 11 percent.

Solution—Accounting Treatment of Syndication Fees. Instant Bank Corp. retains a $1,000,000, 10-percent loan that promises four payments of $315,470 each. At an effective yield of 11 percent, this loan has a present value of $978,703. In this case, part of the fee must be deferred because the yield on the participation retained is less than that received by other participants. The remaining fee is taken into income immediately.

Recognition of syndication fee	
Deferred fee	$ 21,297
Recognized immediately	78,703
	$100,000

6. FEES AND COSTS IN NONTROUBLED REFINANCINGS AND RESTRUCTURINGS

6.1 New Loans

If the terms of a restructuring or refinancing are at least as favorable to the lender as the terms for comparable loans are to new customers with similar credit risks, the lender should treat the modification as a new loan. Any remaining net fees and prepayment penalties on the old loan are recognized in interest income when the new loan is granted.

6.2 Minor Modifications to the Original Loan Contract

Minor modifications to the original loan are not considered to be new loans and, therefore, do not require recognition of the prior loan's net fees or costs and prepayment penalties.

If for a fee a lender, without requiring a loan closing, reduces interest rates on an existing loan because of a general interest-rate decline, the modification is still a refinancing if the yield on the new loan is at least as favorable as the effective yield on comparable loans made to new customers. Any unamortized net fees and costs are recognized in interest income. However, if this is not the case, unamortized net fees and costs from the original loan along with any prepayment penalties are carried forward as part of the net investment in the new loan. If an original loan contract provides for interest-rate modifications, an adjustment for changes in those rates is not considered to be a refinancing.

Modifications in the contractual terms of a mortgage loan for a fee comprise a refinancing, and the accounting that will be used depends on whether the changes constitute minor revisions or new loans.

If the combined loan rate, resulting from blending a loan of new funds at market interest rates with existing loans at lower rates, results in a yield somewhere between the existing and market rates, the unamortized net fees and costs on the existing loan, as well as the net fees and costs relating to the refinancing, carry over to the new loan. This is because the blended rate is below the market rate for the lender's other customers.

7. PURCHASE OF A LOAN OR GROUP OF LOANS

7.1 Accounting

The investment in a purchased loan or group of loans is the amount paid, adjusted for fees paid or received. Accordingly, purchase premiums and discounts are an adjustment to yield and are recognized over the life of the loan. When a purchaser collects a portion of the original lender's origination fee, the basis of the investment is reduced because someone else originated the loan. The difference between the investment and the loan's principal amount at the date of purchase is recognized as an adjustment to yield over the life of the loan. Since these loans were originated by someone else, other costs involved in purchasing the loan are expensed as incurred. Fees paid for portfolio management or investment consultation, whether incurred internally or paid to an independent third party, are treated as other costs incurred in connection with acquiring purchased loans or committing to purchase loans; these fees are charged to expense as incurred.

If a group of loans is acquired, the investment may either be allocated to individual loans or accounted for in the aggregate. If unanticipated prepayments (for example, redemptions or resale of purchased loans) occur, *a portion* of the deferred fees and purchase premiums is recognized, and the effective rate on the remaining loans is unchanged. If a firm holds a large number of similar loans for which prepayments are probable and can be reasonably estimated, the firm may anticipate such prepayments to calculate the effective interest rate. Such a policy as well as the related assumptions should be disclosed.

8. OTHER MATTERS

8.1 Recognition of Deferred Fees When Interest Is Not Recognized

Deferred net fees or costs are not recognized in periods in which interest income is not recognized, that is, *they are part of the loan balance* in assessing collectibility.

8.2 Application to Leasing Activities

Lessors can no longer offset a portion of the unearned income at the inception of the lease against the initial direct costs. Initial direct costs must be accounted for in the same manner as loan origination costs. Similarly, the lessor's practice of offsetting unearned income against the provision for bad debts now is eliminated.

9. CLASSIFICATION

9.1 Balance Sheet

Any unamortized balances consisting of loan origination fees, commitments, other fees and costs, and purchased premiums and discounts, which are deferred and amortized under the interest-rate method, are to be reported as part of the related loan balance. Commitment fees meeting conditions for deferral are not combined with outstanding loan balances but are instead classified within the financial statements as deferred income. Additional disclosures such as unamortized net fees and costs may be reported within the footnotes if helpful to users of the statements.

9.2 Income Statement

Loan origination fees, commitments, and other fees and costs recognized by adjusting yields are reported as interest income. Those commitment and other fees that are amortized on a straight-line basis over the commitment period or included when the commitment expires are designated as service-fee income.

10. ACCOUNTING FOR YIELD ADJUSTMENTS

10.1 Recognition of Yield Adjustments

The interest method as described in Accounting Principles Board Opinion No. 21 (APB 21), *Interest on Receivables and Payables*, is used, with some limited exceptions, to recognize those net fees and costs accounted for as yield adjustments under SFAS 91. Calculations of periodic interest under the interest method result in a constant effective yield on the net investment in the loan. Ordinarily, the interest method is applied on a loan-by-loan basis, using the repayment terms specified in the loan contract and assuming the borrower does not make payments earlier than required. Upon repayment of a portion of the loan, a portion of the unamortized fees and costs are recognized as interest. The contractual payments of principal and interest for a group of loans can be aggregated if the resulting recognition does not differ materially from that recognized on a loan-by-loan basis. Once a lender selects the appropriate method of accounting for a loan or group of loans, the lender must continue to use this method throughout the life of the loan or group.

However, if the company holds a large number of similar loans for which prepayments are probable and both the timing and amount can be reasonably estimated, then the company can use estimates of future principal prepayments to calculate effective rates. Characteristics that should be considered in determining whether loans can be aggregated for purposes of estimating prepayments include the following:

- Loan type and size
- Nature and location of collateral
- Coupon interest rate
- Maturity
- Period of origination
- Prepayment history of loans (if seasoned)
- Level of net fees or costs

- Prepayment penalties
- Interest-rate type
- Expected prepayment performance in varying interest-rate scenarios.

In estimating principal repayments, the lender should consider historical prepayment data. Additionally, external information, including existing and forecasted interest rates, economic conditions, and published mortality rates and prepayment tables for similar loans, should be taken into account.

When there are differences between anticipated premiums under this "pooling-of-loans approach" and actual payments and anticipated future prepayments, the lender must recalculate the effective rate. After such recalculations, the net investment is adjusted to reflect the new amount, assuming that the new effective rate had been applied since the acquisition of the loan. Disclosure of the policy used to anticipate prepayments as well as significant underlying assumptions about prepayment estimates is required.

If a lender sells some of the loans that have been aggregated for purposes of estimating prepayments, a pro-rata calculation of unamortized net fees and costs, based on the ratio of outstanding principal balances of loans sold, is appropriate. Specific identification can be used to calculate gains and losses, if the lender maintains sufficiently detailed records.

If a lender amortizes fees and costs on a loan-by-loan basis, the lender may not estimate prepayments. Net fees and costs should be amortized over the contract life and adjusted, based on actual prepayments.

Accounting for situations discussed above is illustrated in Appendix A (see Cases 1 through 4).

10.2 Applying the Interest Method

If the loan's stated interest rate increases during the term of the loan, interest income should not be recognized to the extent that the net investment in the loan increases above the amount at which the borrower could settle the obligation. However, net investment in an increasing interest rate loan can exceed the amount at which the borrower can settle the obligation, if the excess results from premiums attributable to loan purchases or from loan costs in excess of loan fees, qualifying for deferral under SFAS 91. Cases 5 and 6 in Appendix A illustrate situations in which interest rates are increasing.

If the loan's stated interest rate decreases during the term of the loan, interest received in early years which is excess of that computed under the interest method is deferred and recognized in future years when the computed interest under the interest method exceeds the stated interest. Case 7 illustrates a decreasing interest situation.

If the loan's state interest rate varies, based on changes in a specified index, the calculation of interest under the interest method is based either on the index in effect at the inception of the loan or on the index as it changes over the life of the loan. (The calculation of the revised effective rate under the second alternative is made from the time of the change.) The lender may select one of these two alternatives and must apply the method consistently throughout the life of the loan. As in increasing rate loans, interest is not to be recognized to the extent that the net investment in the loan is increased above the amount at which the borrower could settle the obligation. Prepayment penalties are to be considered in calculating the settlement amount. Case 9 in Appendix A illustrates these situations.

The following amortization methods should be applied to loan fees for the loan arrangements shown below:

Loan Type	*Amortization Method*
Negative amortization loans	Interest
Biweekly mortgages	Interest
Line-of-credit loans	Straight-line
Overdraft protection loans	Straight-line
Home equity loans	Generally, interest method but straight-line if resembles revolving line of credit
Acquisition, development, or construction arrangements accounted for as loans prior to completion of funding:	
Single project	Interest (use estimates if timing and amount of payments are unspecified)
Multiple projects	Ordinarily, interest method but straight-line if resembles line of credit.

10.3 Modifications to the Interest Method

For a demand loan, any net fees or costs are recognized as an adjustment to yield on a straight-line basis over a period consistent with the understanding between borrower and lender or, if no understanding exists, over the lender's estimate of the time over which the loan will be outstanding. The lender's estimates should be monitored and revised as appropriate. If, contrary to expectations, a loan remains outstanding beyond the anticipated date, no adjustment is required.

Net fees or costs on revolving lines of credit are recognized in income on a straight-line basis over the period in which the line is active, assuming that the borrowings are outstanding the maximum term provided in the loan contract. If the borrower pays all borrowings and cannot reborrow, all remaining deferred net fees and costs are recognized in income upon payment. The interest method is used to recognize unamortized net fees and costs when the loan agreement provides a payment schedule and permits no additional borrowing. If a line of credit is repaid, and the revolver remains unused for a period of time even though the borrower has a contractual right to continue to borrow, net fees and costs should be amortized over the full term of the revolver. If a lender grants a 10-year loan with a three-year callable feature, fees should be amortized over the 10-year contract life. A lender grants a 90-day loan and collects a nonrefundable fee approximating market. The lender will defer and amortize the fee over the original 90 days, even though he anticipates, but is not obligated to grant, an additional 90-day extension after reevaluating the outstanding loan and receiving an extension fee.

11. EFFECTIVE DATE AND TRANSITION

SFAS 91 is to be applied prospectively to lending and leasing transactions entered into (initiated) and to commitments granted in fiscal years beginning after December 15, 1987, and interim periods within those fiscal years. Retroactive application, by restatement of all prior years presented, is encouraged but not required. Earlier application is encouraged in fiscal years for which financial statements have not been previously issued. If a business combination is accounted for as a purchase, retroactive adoption requires the restatement of the accounts of the acquired entity subsequent to the acquisition date. In a business combination accounted for as a pooling, all accounts of the historical entity are carried forward at historical costs and are restated for the entire restatement period. When the statement is first applied, the financial statements shall disclose the nature and their effect on income before extraordinary items, net income, and related per-share amounts, if applicable, for the current year and for each restated year presented. If the Statement is adopted prospectively, disclosure of the accounting change and the prior accounting policies shall be continued in financial statements of subsequent years in which outstanding loans accounted for under the prior policy are material.

12. AMENDMENTS TO OTHER PRONOUNCEMENTS

SFAS 91 changes the practice of recognizing loan origination and commitment fees at, or prior to, inception of the loan. SFAS No. 17, *Accounting for Leases—Initial Direct Costs,* is rescinded. SFAS No. 13, *Accounting for Leases,* is amended. SFAS No. 98 *Sale and Leaseback Transactions, Definition of Lease Term and Initial Direct Costs of Direct Financing Leases*, amends SFAS 91, treating initial direct costs as a component of net investment rather than unearned income. SFAS No. 60, *Accounting and Reporting by Insurance Companies*, and SFAS No. 65, *Accounting for Certain Mortgage Banking Activities,* are also amended by SFAS 91.

APPENDIX A

Examples of Application of SFAS 91

This appendix presents examples that illustrate the application of this Statement. The examples and estimates used are illustrative only and are not intended to modify or limit in any way the provisions of this Statement. All examples assume that principal and interest payments are made on the last day of the year.

Case 1. Amortization based on contractual payment terms

On January 1, 19X7, A Company originates a 10-year $100,000 loan with a 10-percent stated interest rate. The contract specifies equal annual payments of $16,275 through December 31, 19Y6. The contract also specifies that no penalty will be charged for prepayments of the loan. A Company charges a 3-percent ($3,000) nonrefundable fee to the borrower and incurs $1,000 in direct loan origination costs (attorney fees, appraisal, title insurance, wages, and payroll-related fringe benefits of employees performing origination activities, outside broker's fee). The carrying amount of the loan is computed as follows:

Loan principal	$100,000
Origination fees	(3,000)
Direct loan origination costs	1,000
Carrying amount of loan	$ 98,000

A Company accounts for this loan using contractual payments to apply the interest method of amortization. In calculating the effective rate to apply the interest method, the discount rate necessary to equate 10 annual payments of $16,275 to the initial carrying amount of $98,000 is approximately 10.4736 percent. The amortization, if no prepayment occurs, is shown in Table 1.

Table 1 *Amortization Based on Contractual Payment Terms*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(98,000)				$100,000		$98,000
1	16,275	$10,000	$ 264	$10,264	93,725	$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	16,275	8,682	257	8,939	79,230	1,217	78,013
4	16,275	7,923	248	8,171	70,878	969	69,909
5	16,275	7,088	234	7,322	61,691	735	60,956
6	16,275	6,169	215	6,384	51,585	520	51,065
7	16,275	5,159	189	5,348	40,469	331	40,138
8	16,275	4,047	157	4,204	28,241	174	28,067
9	16,275	2,824	116	2,940	14,790	58	14,732
10	16,275	1,485[a]	58	1,543	0	0	0
Total amortization			$2,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for prior year × the effective interest rate (10.4736%)[b]
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[a] $6 rounding adjustment.

[b] The effective interest rate is the discount rate that equates the present value of the future cash inflows to the initial net cash outflow of $98,000.

Case 2. Amortization based on contractual payment terms with full prepayment in year 3 [and Case 2A with partial repayments]

On January 1, 19X7, B Company originates a 10-year $100,000 loan with a 10-percent stated interest rate. The contract specifies equal annual payments of $16,275 through December 31, 19Y6. The contract also specifies that no penalty will be charged for prepayments of the loan. B Company charges a 3-percent ($3,000) nonrefundable fee to the borrower and incurs $1,000 in direct loan origination costs.

B Company accounts for this loan using contractual payments to apply the interest method of amortization. The amortization if the borrower prepays the remaining principal at the end of year 3 is shown in Table 2.

Table 2 *Amortization Based on Contractual Payment Terms with Full Prepayment in Year 3*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(98,000)				$100,000		$98,000
1	16,275	$10,000	$ 264	$10,264	93,725	$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	95,505	8,682	1,474	10,156	0	0	0
Total amortization			$2,000				

Computations:
Column (1)—Contractual payments + prepayments
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for prior year × the effective interest rate (10.4736%) plus in year 3 an adjustment of $1,217 representing the unamortized net fees recognized when the loan is paid in full
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

Case 2A. Amortization based on contractual payments with partial prepayment in period 3

Year	Cash (Out) Inflow	Stated Interest	Amortization	Interest Income	Remaining Principal	Unamortized Net Fees	Carrying Amount
	$(98,000)				$100,000		$98,000
1	16,275	$10,000	$ 264	$10,264	93,725	$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	26,275	8,682	407(4)	9,089	69,230	1,067(3)	68,013(2)
4	14,220(1)	6,923	216	7,139	61,933	851	61,082
5	14,220	6,193	204	6,397	53,906	647	53,259
6	14,220	5,391	187	5,578	45,077	460	44,617
7	14,220	4,508	165	4,673	35,365	295	35,070
8	14,200	3,537	136	3,673	24,682	159	24,523
9	14,220	2,469[a]	99	2,568	12,931	60	12,871
10	14,220	1,289[b]	60	1,349[a]	0	0	0
			$2,000				

[a]$1.00 rounding adjustment

[b]$4.00 rounding adjustment

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Case 3. Amortization based on estimated prepayment patterns

On January 1, 19X7, C Company originates 1,000 10-year $10,000 loans with 10-percent stated interest rates. Each contract specifies equal annual payments through December 31, 19Y6. The contracts also specify that no penalty will be charged for prepayments. C Company charges each borrower a 3-percent ($300) fee and incurs $100 in direct origination costs for each loan. The carrying amount of the loan is computed as follows:

Loan principal amounts	$10,000,000
Origination fees	(300,000)
Direct loan origination costs	100,000
Carrying amount of loans	$ 9,800,000

C Company chooses to account for this large number of loans using anticipated prepayment patterns to apply the interest method of amortization. C Company estimates a constant prepayment rate of 6 percent per year, which is consistent with C Company's prior experience with similar loans and C Company's expectation of ongoing experience. The amortization when prepayments occur as anticipated is shown in Table 3.

Case 4. Amortization based on estimated prepayment patterns adjusted for change in estimate

On January 1, 19X7, D Company originates 1,000 10-year $10,000 loans with 10-percent stated interest rates. Each contract specifies equal annual payments through December 31, 19Y6. The contracts also specify that no penalty will be charged for prepayments. D Company charges each borrower a 3-percent ($300) fee and incurs $100 in direct origination costs for each loan.

D Company chooses to account for this portfolio of loans using anticipated prepayment patterns to apply the interest method of amortization. D Company estimates a constant prepayment rate of 6 percent per year, which is consistent with D Company's prior experience with similar loans and D Company's expectation of ongoing experience.

Table 4 illustrates the adjustment required by paragraph 19 of SFAS 91 when an enterprise's actual prepayment experience differs from the amounts anticipated. The loans have actually prepaid at a rate of 6 percent in years 1 and 2 and 20 percent in year 3. Based on the new information at the end of year 3, D Company revises its estimate of prepayment experience to anticipate that 10 percent of the loans will prepay in year 4 and 6 percent of the loans will prepay in remaining years. The carrying amount of the loans at the

Table 3 *Amortization Based on Estimated Prepayment Patterns*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(9,800,000)				$10,000,000		$9,800,000
1	2,227,454	$1,000,000	$ 35,141	$1,035,141	8,772,546	$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	1,880,619	760,018	28,724	788,742	6,479,577	104,189	6,375,388
4	2,719,716	647,958	25,453	673,411	5,407,819	78,736	5,329,083
5	1,566,144	540,782	22,111	562,893	4,382,457	56,625	4,325,832
6	1,419,028	438,246	18,677	456,923	3,401,675	37,948	3,363,727
7	1,277,230	340,168	15,131	355,299	2,464,613	22,817	2,441,796
8	1,138,934	246,461	11,458	257,919	1,572,140	11,359	1,560,781
9	1,000,180	157,214	7,646	164,860	729,174	3,713	725,461
10	802,091	72,917	3,713	76,630	0	0	0
Total amortization			$200,000				

Computations:
Column (1)—Contractual payments + 6% of Column (5) for the prior year (except in year 10)
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for prior year × the effective interest rate (10.5627%)
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

Table 4 *Amortization Based on Estimated Prepayment Patterns Adjusted for a Change in Estimate*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(9,800,000)				$10,000,000		$9,800,000
1	2,227,454	$1,000,000	$ 35,141	$1,035,141	8,772,546	$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	2,944,644	760,018	41,951	801,969	5,415,552	90,962	5,324,590
4	1,653,939	541,555	23,294	564,849	4,303,168	67,668	4,235,500
5	1,246,229	430,317	18,998	449,315	3,487,256	48,670	3,438,586
6	1,129,164	348,726	16,050	364,776	2,706,818	32,620	2,674,198
7	1,016,331	270,682	13,005	283,687	1,961,169	19,615	1,941,554
8	906,285	196,117	9,849	205,966	1,251,001	9,766	1,241,235
9	795,875	125,100	6,574	131,674	580,226	3,192	577,034
10	638,249	58,023	3,192	61,215	0	0	0
Total amortization			$200,000				

Computations:
Column (1)—Contractual payments + prepayments
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for prior year × the effective rate (10.5627% for years 1 and 2, and 10.6083% for years 3-10, + an adjustment of $8,876 in year 3 representing the cumulative effect[c] applicable to years 1 and 2 of changing the estimated effective rate)
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[c]An adjustment would also be required if the level of prepayments realized was less than anticipated.

end of year 3 is adjusted to the amount that would have existed had the new effective yield been applied since January 1, 19X7. Included in amortization in year 3 is an adjustment for the difference in the prior effective yield and the new effective yield applied to amounts outstanding in years 1 and 2. Amortization in years 4 to 10 assumes the new estimates of prepayment experience occur as anticipated.

Case 5. Application of paragraph 18(a)—when the loan's prepayment penalty is effective throughout the entire term

E Company grants a 10-year $100,000 loan with an 8-percent stated interest rate in year 1 and 10-percent in years 2 to 10. E Company receives net fees of $1,000 related to this loan. The contract specifies that the borrower must pay a penalty equal to 1 percent of any principal prepaid. Application of the effective yield to recognize an amount in excess of net fees is appropriate for a loan with an increasing stated interest rate, only to the extent that the loan agreement provides for a prepayment penalty that is effective throughout the loan term. (See Table 5.)

Case 6. Application of paragraph 18(a)—with no prepayment penalty

F Company grants a 10-year $100,000 loan. The contract provides for 8-percent interest in year 1 and 10-percent interest in years 2 to 10. F Company receives net fees of $1,000 related to this loan. The contract specifies that no penalty will be charged for prepayment of principal.

The discount factor that equates the present value of the cash inflows in Column 1, Table 6, with the initial cash outflow of $99,000 is 9.8085 percent. In year 1, recognition of interest income on the investment of $99,000 at a rate of 9.8085 percent would cause the investment to be $93,807, or $710 greater than the amount at which the borrower could settle the obligation. Because the condition set forth in paragraph 18(a) is not met, recognition of an amount greater than the net fee is not permitted.

Case 7. Application of paragraph 18(b)

G Company grants a 10-year $100,000 mortgage. G Company receives net fees of $1,000 related to this loan. The contract provides for an interest rate of 12 percent in year 1, 11 percent in year 2, and 10 percent thereafter. (See Table 7.)

Table 5 *Application of Paragraph 18(a)—When the Loan's Prepayment Penalty Is Effective Throughout the Entire Term*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees[d]	(7) Carrying Amount	(8) Settlement Amount
	$(99,000)				$100,000		$99,000	
1	14,903	$8,000	$1,710	$9,710	93,097	$(710)	93,807	$94,028
2	16,165	9,310	(108)	9,202	86,242	(602)	86,844	87,104
3	16,165	8,624	(106)	8,518	78,701	(496)	79,197	79,488
4	16,165	7,870	(102)	7,768	70,406	(394)	70,800	71,110
5	16,165	7,041	(97)	6,944	61,282	(297)	61,579	61,895
6	16,165	6,128	(88)	6,040	51,245	(209)	51,454	51,757
7	16,165	5,124	(78)	5,046	40,204	(131)	40,335	40,606
8	16,165	4,021	(65)	3,956	28,060	(66)	28,126	28,340
9	16,165	2,806	(47)	2,759	14,701	(19)	14,720	14,848
10	16,165	1,464[e]	(19)	1,445	0	0	0	0
Total amortization			$1,000					

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in year 1, 10% in years 2-10)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (9.8085%)
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)
Column (8)—Column (5) × 1.01 (to calculate the settlement amount including prepayment penalty)

[d] Unamortized net fee and accrued interest.

[e] $6 rounding adjustment.

Table 6 *Application of Paragraph 18(a)—With No Prepayment Penalty*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(99,000)				$100,000		$99,000
1	14,903	$8,000	$1,000	$9,000	93,097	$0	93,097
2	16,165	9,310	0	9,310	86,242	0	86,242
3	16,165	8,624	0	8,624	78,701	0	78,701
4	16,165	7,870	0	7,870	70,406	0	70,406
5	16,165	7,041	0	7,041	61,282	0	61,282
6	16,165	6,128	0	6,128	51,245	0	51,245
7	16,165	5,124	0	5,124	40,204	0	40,204
8	16,165	4,021	0	4,021	28,060	0	28,060
9	16,165	2,806	0	2,806	14,701	0	14,701
10	16,165	1,464[f]	0	1,464	0	0	0
Total amortization			$1,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in year 1, 10% in years 2-10)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (9.8085%) as limited by paragraph 18(a) of this Statement
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[f]$6 rounding adjustment.

Table 7 *Application of paragraph 18(b)*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees[g]	(7) Carrying Amount
	$(99,000)				$100,000		$99,000
1	17,698	$12,000	$(1,259)	$10,741	94,302	$2,259	92,043
2	17,031	10,373	(388)	9,985	87,644	2,647	84,997
3	16,428	8,764	458	9,222	79,980	2,189	77,791
4	16,428	7,998	441	8,439	71,550	1,748	69,802
5	16,428	7,155	418	7,573	62,277	1,330	60,947
6	16,428	6,228	385	6,613	52,077	945	51,132
7	16,428	5,208	339	5,547	40,857	606	40,251
8	16,428	4,086	281	4,367	28,515	325	28,190
9	16,428	2,852	206	3,058	14,939	119	14,820
10	16,428	1,489[h]	119	1,608	0	0	0
Total amortization			$ 1,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (12% in year 1, 11% for year 2, and 10% in years 3-10)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for the prior year × effective interest rate (10.8491%)
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[g]Unamortized net fee and deferred interest.

[h]$5 rounding adjustment.

Case 8. Application of paragraph 18(c)—amortization based on factor at inception

H Company grants a 10-year variable rate mortgage. The loan's interest rate and payment are adjusted annually based on the weekly Treasury bill index plus 1 percent. At the date the loan is granted, this index is 7 percent and does not change until the end of year 3. The first year loan interest rate is 8 percent (equal to the Treasury bill index plus 1 percent). H Company receives net fees of $3,000. At the end of year 3, the index changes to 9 percent and does not change again. Therefore, the loan's stated interest rate is 8 percent for years 1 to 3 and 10 percent for years 4 to 10. H Company chooses to determine the amortization based on the index at the date the loan is granted and to ignore subsequent changes in the factor. (See Table 8.)

Case 9. Application of paragraph 18(c)—amortization recalculated for subsequent changes in factor

I Company grants a 10-year variable rate mortgage. The loan's interest rate and payment are adjusted annually based on the weekly Treasury bill index plus 1 percent. At the date the loan is granted, this index is 7 percent and doesnot change until the end of year 3. The first year loan interest rate is 8 percent (equal to the Treasury bill index plus 1 percent). I Company receives net fees of $3,000. At the end of year 3, the index changes to 9 percent and does not change again. Therefore, the loan's stated interest rate is 8 percent for years 1 to 3 and 10 percent for years 4 to 10. I Company chooses to recalculate a new amortization schedule each time the loan's index changes.

Table 8 *Application of Paragraph 18(c)—Amortization Based on Factor at Inception*

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(97,000)				$100,000		$97,000
1	14,903	$8,000	$ 420	$8,420	93,097	$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,937	7,729	375	8,134	69,412	1,400	68,012
5	15,937	6,941	347	7,288	60,416	1,053	59,363
6	15,937	6,042	314	6,356	50,521	739	49,782
7	15,937	5,052	272	5,324	39,636	467	39,169
8	15,937	3,964	221	4,185	27,663	246	27,417
9	15,937	2,766	160	2,926	14,492	86	14,406
10	15,937	1,445[i]	86	1,531	0	0	0
Total amortization			$3,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in years 1-3, and 10% in years 4-10)
Column (3)—Calculated as if the index did not change—that is, the amount that would have been recognized for an 8%, 10-year $100,000 mortgage with no prepayments and a $3,000 net fee
Column (4)—Column (2) + Column (3)
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[i]$4 rounding adjustment.

Table 9 *Application of Paragraph 18(c)—Amortization Recalculated for Subsequent Changes in Factor*

Year	*(1) Cash (Out) Inflow*	*(2) Stated Interest*	*(3) Amortization*	*(4) Interest Income*	*(5) Remaining Principal*	*(6) Unamortized Net Fees*	*(7) Carrying Amount*
	$(97,000)				$100,000		$97,000
1	14,903	$8,000	$ 420	$8,420	93,097	$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,937	7,759	358	8,117	69,412	1,417	67,995
5	15,937	6,941	340	7,281	60,416	1,077	59,339
6	15,937	6,042	311	6,353	50,521	766	49,755
7	15,937	5,052	275	5,327	39,636	491	39,145
8	15,937	3,964	227	4,191	27,663	264	27,399
9	15,937	2,766	168	2,934	14,492	96	14,396
10	15,937	1,445[j]	96	1,541	0	0	0
Total amortization			$3,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in years 1-3, and 10% in years 4-10)
Column (3)—Column (4) − Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (8.6809%) for years 1-3 and Column (7) for the prior year × the effective interest rate (10.7068%) for years 4-10
Column (5)—Column (5) for prior year − (Column (1) − Column (2))
Column (6)—Initial net fees − amortization to date
Column (7)—Column (5) − Column (6)

[j] $4 rounding adjustment.

CHAPTER 6
The FASB Emerging Issues Task Force

CHAPTER 6

The FASB Emerging Issues Task Force

1. INTRODUCTION

In 1984, the Financial Accounting Standards Board (FASB) created the Emerging Issues Task Force (EITF) in response to a pressing need for more timely guidance on new accounting issues. The recent proliferation of innovative business transactions has triggered a number of complex accounting issues, many of which are narrow implementation issues or industry-specific. However, the FASB's due process mechanism by nature limits the Board's ability to deal promptly with these issues. What's more, within the profession, there is a growing concern about a "standards overload," that is, addressing narrow issues by issuing new pronouncements.

The EITF includes representatives from both accounting firms and industry. Presently, there are eleven accounting firms and four major corporations represented on the task force, which is chaired by the FASB director of research and technical activities. In addition, an SEC observer, ordinarily the chief accountant, actively participates in EITF meetings.

Through the cooperative efforts of practitioners, the FASB, and the SEC, the EITF addresses, and ultimately resolves, many of these narrow issues without formal due process procedures. In other words, the EITF shapes practice without setting standards. In Staff Accounting Bulletin No. 57, Footnote 4, the SEC indicated that it will assist in identifying, and in some cases resolving, complex accounting issues. The commission stated:

> the authoritative accounting literature cannot specifically address all the novel and complex business transactions into which registrants might enter. . . . The [SEC] staff intends to participate in the activities of [the task force] and believes the group's efforts will be most effective if preparers of financial statements and/or their independent accountants apprise the group of intended accounting for new business transactions.

While serving as SEC chief accountant, Clarence Sampson indicated that SEC registrants will be called upon to justify accounting that differs from a consensus reached by the EITF.

2. TASK FORCE OPERATING PROCEDURES

Approximately every six weeks, EITF members hold a meeting to discuss issues that have been placed on the agenda. For each issue, members of either the task force or the FASB staff prepare an Issues Summary Package comprising an Issue Summary Form and other attachments. While most Issue Summary Packages attempt to present a neutral discussion of the issue, they sometimes advocate accounting positions. Views contained within an Issue Summary Package represent the views of the preparer prior to the task force's discussion. Also attached to each Issue Summary Package are extracts from the minutes of each task force meeting at which the issue is discussed. An issue is summarized at the meeting by the EITF member who raised it or by a member of the FASB staff. Following the discussion, the chairman polls EITF members to ascertain whether or not there is a consensus on the issue. If fewer than three members object, the consensus is recorded in the minutes. In some situations, the discussion is inconclusive, and various aspects may be further discussed in subsequent meetings. Even if a consensus is not reached during a meeting, the FASB obtains insights about members' views on particular transactions; areas where guidance is required on a timely basis; areas where guidance awaits work on an existing FASB project; and areas where further guidance is not required.

3. NATURE OF ISSUES EXAMINED

As of October 6, 1988, the EITF has discussed 190 accounting issues, which have been categorized in Appendix A. Of these 190 issues, 80 were related either to financial institutions or to financial instruments. Detailed listings of these accounting issues by group are available.

4. DISPOSITION OF ISSUES

Appendix B provides the disposition of the 190 accounting issues accepted for consideration by the EITF. Of that amount, 115 issues addressed by the EITF were resolved by consensus, while 23 issues were resolved by the FASB. Actions settling these issues include a number of Technical Bulletins and FASB Statements. Issue 84-3, *Convertible Debt Sweeteners*, was resolved by Statement of Financial Accounting Standards (SFAS) No. 84, *Induced Conversions of Convertible Debt.* Issue 85-4, *Common Control Questions*, was resolved by FASB Technical Bulletin (TB) 85-5, *Issues Relating to Accounting for Business Combinations.* Twenty-three issues have not been resolved under the EITF framework.

5. ACCESSING AND RESEARCHING ISSUES ADDRESSED BY THE EITF

The FASB offers a subscription plan for task force materials, which includes Issues Summary Packages and final minutes of meetings.

The FASB prepares an EITF Summary, which provides the following for each issue considered by the EITF:

- Description of issue
- Dates discussed/minute references
- Disposition; consensus reached; FASB/SEC document released; other.

In addition, issues are grouped by type. Examples are provided in Appendixes C and D pertaining to business combinations and income taxes.

The professional researching an accounting issue can obtain from the FASB an EITF Summary and Analysis of Issues Grouped by Type to see if the task force might have already addressed a particular problem. Summary packets and minutes can be ordered individually from the FASB. The AICPA NAARS data base contains task force minutes and issues summaries, as well as the index to the issues and their dispositions. The FASB also publishes EITF Abstracts, which summarize the task force's proceedings. A separate abstract is presented for each issue considered by the task force. A comprehensive topical index facilitates quick identification of relevant issues.

6. ANALYSIS OF SELECTED ISSUES

6.1 Issue 86-46—Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986

This Issue involves the 1986 Tax Reform Act, which establishes new rules for the capitalization of costs for inventories. Inventory costs both for goods manufactured and for those acquired for resale are affected by the new provisions. Capitalization is required for certain direct as well as indirect costs, which benefit inventory that is either produced or acquired for resale. Most of these costs have been previously charged to expense for both tax and accounting purposes. The issue is whether or not these costs are capitalizable under generally accepted accounting principles (GAAP), and, if so, are the new costing methods preferable under GAAP.

6.1.1 Consensus

The fact that a cost is capitalizable for taxes does not make it preferable or appropriate for financial reporting purposes. Costs that are capitalizable for taxes may be capitalizable for financial reporting purposes, but that depends on individual facts and circumstances.

6.1.2 Discussion Issue 86-46

How might this issue be researched? Accounting Research Bulletin (ARB) No. 43, Chapter 4, on inventory pricing indicates that inventory should be stated at cost, which in this case means acquisition and production cost. ARB 43 also states that the exclusion of overhead is not GAAP. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, addresses how to report and justify changes in accounting principles. Finally, FASB Interpretation (FASI) No. 1, *Accounting Changes Related to the Cost of Inventory*, states that a change in the composition of the elements of costs included in inventory is treated as an accounting change. Also, preferability among principles must be determined on the basis of whether the new principle constitutes an improvement in financial reporting, not on the basis of the income tax effect alone.

Now the issue is whether the types of costs required to be allocated to inventories would be capitalizable under GAAP, and, if so, whether the new cost method is preferable for justifying a change.

The EITF concluded that some costs may be capitalizable depending on the firm's operation and industry practices. However, the fact that these costs are capitalizable for taxes is insufficient in itself.

6.2 Issue 86-9—IRC Section 338 and Push-Down Accounting

Under the Tax Equity and Fiscal Responsibility Act *(TEFRA)*, enacted in 1982, an acquired company can obtain a stepped-up basis without actually liquidating. Two issues were addressed by EITF:

- Is push-down required in an acquisition when (a) the acquired company is not a party to the transaction effecting change in ownership (b) a step-up in basis is elected and (c) no compelling reasons exist for keeping the old basis?
- Assuming continuation of the old basis, how is the consolidated tax provision to be allocated?

6.2.1 Consensus

For companies that are non-SEC registrants, push-down is not required. Any of the following methods of allocating the consolidated tax provision can be used, as long as the choice is accompanied by appropriate disclosures:

- Allocate on the pre-acquisition tax basis and modify accordingly the intercorporate tax allocation agreement
- Credit the tax benefit from the tax basis step-up to capital surplus when realized
- Credit the tax benefit to income as a permanent difference when realized

6.3 Issue 87-13—Amortization of Prior Service Cost for a Defined Benefit Plan When There Is a History of Amendments

The Issue involves whether an employer's history of granting regular amendments to a defined plan suggests that economic benefits from granting these retroactive benefits should be spread over a shorter period than the remaining service period of active employees. Under paragraph 27 of SFAS No. 88, *Employers' Accounting for Settlements and Curtailments* *of Defined Benefit Pension Plans and for Termination of Benefits*, an assessment is made of the individual circumstances and substance of the plan to determine if there is more rapid expiration of the employer's benefits as well as a need for faster amortization. The question raised is whether paragraph 27 presumes amortization of prior service costs over the contract period without additional evidence.

The task force wasn't required to reach a consensus in this case. In fact, EITF members found sufficient guidance in the FASB Special Report, "A Guide To Implementation of Statement 87 on Employer's Accounting for Pensions: Questions and Answers." Question 20 of that report indicates that SFAS No. 87, *Employers' Accounting for Benefits*, does not presume amortization over the contract period.

Question 20 involved a case where an employer had a history of granting retroactive amendments every three years. The question was whether the unrecognized prior service costs were to be amortized over that three-year period. The finding was that the period may be three years if, for example, the retroactive plan amendments were part of union negotiations. In such a situation, employees may expect this pattern of regular amendments to continue. Accordingly, those future economic benefits may expire if the pattern is broken. This might effectively suggest that the future economic benefits of each retroactive plan amendment expire over the union contract. Facts and circumstances dictate the appropriate amortization period.

6.4 Issue 88-1—Determination of Vested Benefit for a Defined Benefit Plan

This Issue involves the measurement of vested benefits, that is, those benefits for which an employee's right to receive a present or future benefit is no longer contingent on remaining in the employer's service. Two alternative measurement approaches have been used in practice. Under one approach, the vested benefit obligation is the value of vested benefits if the employee separates immediately. Under the second approach, the vested benefit obligation is the expected value of benefits to which an employee is entitled if the employee separates at the expected date of separation or retirement (that is, assumes continued future service).

Under the first approach, vested benefit obligation can exceed the present value of accumulated benefit obligation and/or project benefit obligation. Accordingly, the accumulated benefit obligation and/or project benefit obligation would be increased to the amount of the vested benefit. This affects the amount of periodic pension costs, accrued/prepaid pension costs, and disclosure. An example cited in the Issue is the Italian severance pay statute, under which the benefit an employee has accrued for service provided to date is payable immediately on termination or separation. Accordingly, the statute leads to a situation where benefits immediately payable exceed the discounted value of benefits at the projected retirement date.

6.4.1 Consensus

Either approach is acceptable for situations not specifically addressed in SFAS 87 and for those with facts and circumstances analogous to situations considered by the task force. Note that the SEC Observer called for disclosure of the method used.

6.4.2 Discussion Issue 88-1

In applying SFAS 87, a difficulty arises regarding whether the amount of the vested benefit is determined assuming the employee actually separates immediately, or assuming the employee remains in service until the date of separation or retirement. Under the former approach, vested benefit obligation is the maximum amount to which the employee is currently entitled; under the latter, vested benefit is the present value of the maximum amount. Under SFAS 87, the projected benefit obligation is determined as the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date (incorporates future compensation levels). Accumulated benefit obligation is calculated in the same way as projected benefit obligation, without taking into account future compensation levels. Accumulated benefit obligation consists of vested and invested benefits. Projected benefit obligation is accumulated benefit plus the effects of future compensation levels. Accordingly, if vested benefits exceed accumulated benefit, this affects the measurement of the minimum amount of accumulated benefits. Vested benefits under the first approach can also exceed projected benefit obligation, and that amount then would be increased to the minimum affecting the provision for pension expense.

The FASB staff used the first approach to respond to inquiries. Those in favor of this approach argue that the vested benefit is a present benefit not requiring any discounting, and it is viewed as a liability if the plan is currently discontinued. Supporters of the second approach argue that vested benefits may be payable presently or at some future date. Accordingly, they would determine the vested benefit obligation by projecting the amount to which the employee is currently entitled to the expected date at which these amounts will be paid, and then by discounting.

The first method is inconsistent with paragraph 39 of SFAS 88, which requires that projected benefit obligation be increased by an event that causes employees to leave earlier than expected.

7. HOW TO USE EITF POSITIONS

Cases 1 and 2 illustrate how the professional utilizes EITF positions.

Case 1

Is the practitioner obliged to follow any particular hierarchy of generally accepted principles when researching an accounting question? What is the status of positions rendered by the EITF? Must nonpublic companies follow guidance issued by the task force?

CASE 1 DISCUSSION. Statement on Auditing Standards (SAS) No. 52, *Omnibus Statement on Auditing Standards—1987*, provides the following hierarchy of generally accepted accounting principles:

- The first level includes standards enforceable under Rule 203 of the AICPA's Code of Professional Ethics, such as Financial Accounting Standards Board Statements and Accounting Principles Board Opinions.
- If guidance is not found at the first level, the accountant will look to pronouncements that are not enforceable under Rule 203 but instead are the works of bodies of experts following a due process procedure. A significant due process effort includes the broad distribution of the proposed accounting principles for public comment, with the intent to establish accounting principles or describe existing practices that are generally accepted. Examples are FASB Technical Bulletins and AICPA Statements of Position.
- The next level includes practices or pronouncements that are widely recognized as generally accepted because they represent (a) prevalent practices in a particular industry or (b) the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

- The last level, "other accounting literature," includes AICPA issues papers, EITF Minutes, textbooks, and articles.

The EITF minutes would fall under the category of "other accounting literature." The SEC expects registrants to comply with the consensuses of the EITF since it comprises members of the SEC and the FASB, as well as representatives from public accounting and industry. While an EITF consensus position is not enforceable under Rule 203, it does hold a place in the hierarchy of generally acceptable accounting principles. Since consensus positions of the EITF represent the best thinking in areas in which there are no specific standards, the chief accountant of the SEC has indicated that registrants will be challenged if departing from these positions. Nonpublic companies should also heed this guidance, since the research efforts involved in resolving an issue is heavily reliant on analogies.

Case 2

Solution Shopper Inc. discovers that the EITF has reached a consensus on an accounting issue which differs from the treatment it currently employs. The company decides to conform its accounting practice to that specified by the EITF, but finds that reported assets and income would change significantly from the amounts previously reported. How is the change to be accounted for?

CASE 2 DISCUSSION. Since the EITF is not a standard-setting body, it doesn't address, and ultimately specify, transition provisions. Under APB 20, this change in accounting, which is voluntarily adopted, would be reported as a cumulative profitability adjustment in the year of the change.

Under FASB No. 20, entitled *Reporting Accounting Changes Under AICPA Statements of Position*, the Board specified that transition provisions specified in a statement of position (SOP) would override APB 20. However, if unspecified in the SOP, then the cumulative catch-up adjustment would apply. Again, for EITF consensus rulings, APB 20 applies.

APPENDIX A
EITF Issues

Grouped by Type (10/6/88)

Type	*Number of Issues*
Income Taxes	22
Financial Institutions	31
Financial Instruments	49
Off-Balance-Sheet Financing	12
Pensions/Employee Benefits	14
Business Combinations	22
Inventory/Fixed Assets/Leases	13
Real Estate	8
Other	19
Total	190

APPENDIX B
EITF Issues

Disposition (10/6/88)

Disposition	*Number of Issues*
Consensus Was Reached	115
Resolved by FASB	23
Resolved by SEC	4
Resolved by AICPA	1
FASB Staff Work In Progress	3
AICPA Committee Work In Progress	1
Issues To Be Addressed in an FASB Major Project	6
No Resolution	23
Further Discussion by Task Force Pending	14
Total	190

APPENDIX C
Business Combinations

Analysis of Nature and Disposition

Issue	*Description*	*Disposition*
84-13	Purchase of Stock Options and SARs in Leveraged Buyout	Consensus
84-35	Sale of Duplicate Facility	FASB TB 85-5
84-38	Identical Common Shares for Pooling-of-Interests	FASB TB 85-5
85-2	Classification of Costs in Takeover Defense	FASB TB 85-6
85-4	Common Control Questions	FASB TB 85-5
85-14	Securities That Can Be Acquired for Cash in a Pooling-of-Interests	Consensus
85-21	Changes in Ownership Resulting in a New Basis of Accounting	FASB 94
85-45	Accounting for the Settlement of Stock Options and Awards in a Business Combination	Consensus
86-10	Pooling With 10% Cash Payout Determined by Lottery	Consensus
86-14	Purchased R&D in a Business Combination	No consensus
86-16	Carryover of Predecessor Cost	Consensus
86-20	Accounting for Post-Employment Benefits of an Acquired Company	Consensus
86-31	Reporting the Tax Implications of a Pooling of a Bank and Savings and Loan Association	Consensus
87-11	Allocation of Purchase Price to Assets To Be Sold	Consensus
87-15	The Effect of a Standstill Agreement on Pooling-of-Interests Accounting	Consensus
87-16	Whether the 90 Percent Test in a Pooling-of-Interests Is Applied Separately to Each Company or on a Combined Basis	Consensus
87-21	Change in Basis of Assets in a Public Offering of a Master Limited Partnership	No consensus
87-27	Poolings Involving Companies Not Having a Controlling Class of Common Stock	Consensus
88-14	Settlement of Fees With Extra Units to General Partner in MLP	No consensus
88-16	Basis in Leveraged Buyout of Transactions When Previous Owners' Interest Declines	Further discussion
88-26	Controlling Preferred Stocks in Pooling-of-Interests	Further discussion
88-27	Effects of Unallocated Shares in an ESOP on Accounting for Business Combinations	Further discussion

APPENDIX D

Income Taxes

Analysis of Nature and Disposition of Issues

Issue	*Description*	*Disposition*
84-1	1984 Tax Act: Stock Life Insurance Co	FASB TB 84-3
84-2	1984 Tax Act: Domestic International Sales Corporations	FASB TB 84-2
84-27	Deferred Taxes on Subsidiary Stock Sales	FASB project
84-33	Acquisitions of Tax Loss Carryforwards	Consensus
84-43	Income Tax Effects of Asset Revaluations in Certain Countries	Consensus
85-5	Restoration of Deferred Taxes Previously Eliminated by NOL Recognition	FASB project
85-15	Recognition of Benefits of Purchased NOL Carryforwards	Consensus
86-1	Net Operating Loss Carryforwards	Consensus
86-3	Retroactive Regulations Regarding IRC Section 338 Purchase Price Allocations	Consensus
86-4	Income Statement Treatment of Income Tax Benefit from ESOP Dividends	Consensus
86-9	IRC Section 338 and Push-Down	Consensus
86-11	Recognition of Possible 1986 Tax Law Changes	Consensus
86-33	Tax Indeminifcations in Lease Agreements	Consensus
86-37	Recognition of Tax Benefit of Discounting Loss Reserves of Insurance Companies	Consensus
86-41	Carryforwards of the Corporate Alternative Minimum Tax Credit	Consensus
86-42	Effect of a Change in Tax Rates on Assets and Liabilities Recorded Net of Tax in a Business Combination	Consensus
86-43	Effect of a Change in Tax Law or Rates on Leveraged Leases	Consensus
86-44	Effects of a Change in Tax Law on Investments in Safe Harbor Leases	Consensus
86-46	Uniform Capitalization Rules for Inventory Under Tax Reform Act of 1986	Consensus
87-8	Issues Related to the Accounting for Alternative Minimum Tax	Consensus
87-28	Provisions for Deferred Taxes on Increase in Cash Surrender Value of Life Insurance	No consensus
88-4	Classification of Payment Made to IRS to Retain Fiscal Year	Consensus

CHAPTER 7

Overview of Other Statements and Technical Bulletins

CHAPTER 7

Overview of Other Statements and Technical Bulletins

1. SFAS NO. 92

Issued in August 1987 by the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 92, entitled *Regulated Enterprises—Accounting for Phase-in Plans*, specifies the accounting for phase-in plans and amends SFAS 71, *Accounting for the Effects of Certain Types of Regulation.*

The term "phase-in plan" refers to any method of recognizing allowable costs in rates of a utility that meet all of the following tests:

- The method adopted by the regulator involves either a major, newly completed plant of the regulated enterprise or one of its suppliers, or a major plant scheduled for completion in the near future.
- The method defers the rates intended to recover allowable costs beyond the period in which those costs would be charged to expense under generally accepted accounting principles (GAAP) applicable to nonregulated enterprises.
- The method defers the rates beyond the period that would have been ordered by the rate-making method routinely used for similar costs by that regulator prior to 1982.

If a phase-in plan meets all of the criteria below, all of the allowable costs that are deferred by the regulator for future recovery should be capitalized for financial reporting as a separate asset (a deferred charge):

- The allowable costs are deferred pursuant to a formal plan agreed to by the regulator.
- The plan specifies the timing of recovery of all allowable costs deferred.
- All allowable costs deferred under the plan are scheduled for recovery within 10 years of the dates deferrals begin.
- The percentage increase in rates scheduled for each future year is no greater than the percentage increase in rates scheduled for each immediately preceding year.

1.1 Financial Statement Classification of Amounts Capitalized Under Phase-In Plans

The cumulative amounts capitalized should be reported as a separate asset.

The net amount capitalized in each period, or the net amount of previously capitalized allowable costs that were recovered during each period, should be reported as a separate item of other income or expense.

1.2 Disclosure

1.2.1 Phase-In Plans

Disclosure is required of any phase-in plans that are in effect during the year or have been ordered for future years.

In addition, disclosure must be made of (a) the net amount deferred at the balance-sheet date for rate-making purposes and (b) the net change in deferrals for plans that do not meet SFAS 92 criteria.

1.2.2 Allowance for Earnings on Shareholders' Investments Capitalized for Rate-Making Purposes

The nature and amount of any allowance for earnings on shareholders' investments capitalized for rate-making, but not for financial reporting, purposes must also be disclosed.

1.3 Effective Date and Transition

SFAS 92 is effective for fiscal years beginning after December 15, 1987. Earlier application is encouraged.

Retroactive application is also permitted. If the financial statements of prior years are not restated, then the cumulative-effect approach found in Accounting Priniciples Board (APB) Opinion No. 20, *Accounting Changes*, should be followed.

At the date of initial application, any capitalized cost of existing phase-in plans that do not meet the criteria should be written off.

2. SFAS NO. 93

Issued by the FASB in August 1987, SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires the recognition of depreciation by not-for-profit organizations on their long-lived tangible assets in general purpose external financial statements. An exception is made for works of art or historical treasures whose economic benefit or service potential is slowly used up, resulting in estimated lives that are extraordinarily long. However, this exception is applicable only if existing evidence can verify that—

- The individual asset has cultural, aesthetic, or historical value that is worth preserving in perpetuity.
- The holder has the technological and financial ability to protect and preserve the asset essentially undiminished, and is doing that.

The disclosure required is similar to that generally required for fixed assets in accordance with the provisions of APB Opinion No. 12, *Omnibus Opinion—1967*.

2.1 Effective Date and Transition

SFAS 93 was effective for fiscal years beginning after May 15, 1988, with earlier application encouraged.

The Statement is to be applied retroactively by restating the financial statements of any prior years presented. The disclosure of the effects of restatement is also required.

SFAS 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations*, defers the effective date to fiscal years beginning on or after January 1, 1990.

3. SFAS NO. 97

Issued by the FASB in December 1987, SFAS 97, entitled *Accounting and Reporting by Insurance Enterprises for Certain Insurance Contracts*, is applicable to—

- Universal life-type contracts.
- Long-duration, limited-payment contracts.
- Investment contracts.

In addition, the Statement amends the reporting of realized investment gains and losses in SFAS 60, *Accounting and Reporting by Insurance Enterprises*; the amendment was enacted largely to stem abuses reported by the SEC.

3.1 Three New Contract Forms

New forms of life insurance contracts that have evolved over the past decade encompass different risks and benefits than the insurance contracts to which SFAS 60 applies. These new contracts are characterized by (a) an increased flexibility and discretion granted to one or both parties and (b) the role of an account balance in contract operation. SFAS 97 addresses the accounting and reporting for the following types of new contracts:

- Universal life-type contracts include those contracts providing either death or annuity benefits and having one or more of the following features:
  - — The contract account balance with the policyholder is credited with premiums and interest, and charged for administration, mortality coverage, initiation, and surrender.
  - — One or more of the amounts assessed by the insurer against the policyholder, including amounts assessed for mortality coverage, administration, initiation, and surrender, are not fixed or guaranteed by the terms of the contract.
  - — Amounts that accrue to the benefit of the policyholder, including interest accrued to policyholder balances, are not fixed and guaranteed by the terms of the contract.
  - — Premiums may be varied at the discretion of the policyholder within contract limits and without consent of the insurer.
- Limited-payment contracts are long-duration contracts with terms that are fixed and guaranteed; they are purchased with a limited number of premiums.
- Investment contracts are long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity. A mortality or morbidity risk is present if the insurance enterprise is required to make payments or to forego future premiums upon the death or disability, or the continued survival of, a specific individual or group of individuals.

3.1.1 Limited-Payment Contracts

SFAS 97 essentially divides the universe of limited-payment contracts into two classes:

- For those investment contracts that do not subject the insurer to risks arising from policyholder mortality or morbidity, premiums are recorded as a liability and accounted for consistent with other interest-bearing obligations.
- For those limited-payment contracts that subject the insurer to risks of policyholder mortality or morbidity, an insurance reserve, known as the liability for policy benefits, is to be established in accordance with the provisions of SFAS 60. Gross premiums in excess of acquisition costs and the liability for policy benefits are deferred and recognized over the period in which benefits are provided in a constant relationship to the amount of insurance in force.

3.1.2 Universal Life-Type Contracts—Retrospective Deposit Method Under SFAS 97

Premiums collected are not reported as revenue but are credited to the policyholder's account balance. Revenues from such contracts include amounts assessed against the policyholder for mortality risk and contract servicing, and they are reported in the period assessed, unless the assessment covers services for more than one period.

Amounts charged against the policyholder's account balances as initiation or front-end fees are reported as unearned revenue and are amortized using the same assumptions and factors used to amortize capitalized acquisition costs.

Capitalized acquisition costs are amortized over the life of a block or "book" of universal life-type contracts, based on the present value of the estimated gross profit amounts expected to be realized over the life of that block of contracts. The present value is computed by using the rate of interest that accrues to the policyholder's balance.

In computing amortization, interest should accrue on the unamortized balance and unearned revenue at the rate used to discount expected gross profits.

Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income for the period in which the replacement occurs.

3.2 Reporting Investment Gains and Losses

Realized gains and losses on all investments are reported in the income statement as a component of operating income on a pretax basis. The amount is reported as a separate line item or may be disclosed in the notes to the financial statements. SFAS 60 required that realized gains and losses be reported in the income statement as a separate line item, below operating income and net of applicable income taxes. Realized gains and losses may *not* be deferred under any circumstance.

3.3 Effective Date and Transition

SFAS 97 is effective for fiscal years beginning after December 15, 1988.

The Statement encourages earlier application as well as the restatement of previously issued financial statements. However, if the restatement of all years presented is not practicable, the cumulative effect of applying the proposed Statement should be included in net income in the year of adoption.

4. SFAS NO. 98

In May 1988, the FASB issued SFAS No. 98, entitled *Accounting for Leases: Sale and Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of Lease Term, and Initial Direct Costs of Direct Financing Leases.* SFAS 98 supersedes paragraph 40 of SFAS No. 66, *Accounting for Sales of Real Estate,* which covers situations in which the sale of property is accompanied by a leaseback to the seller. In addition, the Statement rescinds SFAS No. 26, *Profit Recognition on Sales-Type Leases of Real Estate,* as well as Technical Bulletin No. 79-11, *Effects of a Penalty on the Term of a Lease.* SFAS 98 also amends SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases,* as it relates to the accounting for initial direct costs in direct financing leases.

SFAS 98 establishes standards of financial accounting and reporting by seller-lessees for sale and leaseback transactions involving real estate or real estate with equipment.

In addition, the Statement contains amendments to SFAS 13, *Accounting for Leases,* which relate to the definition of a lease term for which there is a loan outstanding from the lessee to the lessor or there is a penalty provision as defined.

SFAS 98 also clarifies SFAS 91 provisions regarding the treatment of initial direct costs in a direct financing lease, and it amends SFAS 13 to reflect the amendment intended by SFAS 91.

4.1 Sale and Leaseback Transaction

A sale and leaseback transaction involving real estate or real estate with equipment must qualify as a sale under the provisions of SFAS 66, as amended by SFAS 98, before it is appropriate for the seller-lessee to account for the transaction as a sale. If the transaction does not qualify as a sale, it would be accounted for either under the deposit method or as a financing transaction.

A lease involving real estate is required to have ownership of the property transferred to the lessee by the end of the lease term in order to qualify as a sales-type lease. Real estate sale and leaseback transactions should be accounted for in accordance with SFAS 98 provisions.

A sale and leaseback transaction that involves real estate or real estate with equipment, and includes any continuing involvement—other than a leaseback—by which the seller-lessee intends to actively use the property from the inception of the lease, would be accounted for either under the deposit method or as a financing transaction.

SFAS 98 specifies the criteria for sale-leaseback accounting to include all of the following:

- A normal leaseback involves the active use of the property by the seller-lessee. Active use refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing is a minor possibility.
- Payment terms and provisions adequately demonstrate the buyer-lessor's initial and continuing investment in the property, as noted in SFAS 66.
- Payment terms and provisions transfer all of the other risks and rewards of ownership, as demonstrated by the absence of any other continuing involvement by the seller-lessee.

4.1.1 Continuing Involvement

SFAS 66 describes some transactions that contain forms of the seller's continuing involvement with the property, resulting in the seller-lessee *not* transferring the risks of ownership to the buyer. Two examples of continuing involvement specified by this Statement that are most frequently found in sale and leaseback transactions are:

- The seller-lessee is obligated to repurchase the property or the buyer-lessor can compel the seller-lessee, or give the seller-lessee an option, to repurchase the property. (This provision excludes the right of first refusal based on a bona fide offer by a third party.)
- The seller-lessee guarantees the buyer-lessor's investment or return on that investment for a limited or extended period of time.

Other provisions or conditions that constitute continuing involvement for the purpose of applying SFAS 66 include, but are not limited to, the following:

- At the end of the lease term, the seller-lessee is required to pay the buyer-lessor for a decline in the fair value of the property that is below the estimated residual value, unless the payment is based on excess wear and tear of the property and is levied on inspection of the property at the termination of the lease.
- The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds.
- The seller-lessee is not relieved of the obligation under any existing debt related to the property.
- The seller-lessee provides collateral, other than the property directly involved in the sale and leaseback transaction, on behalf of the buyer-lessor, or a party related to the seller-lessee issues a guarantee.
- The seller-lessee's rental is contingent on some predetermined level of future operations of the buyer-lessor.

The following conditions are also examples of continuing involvement for the purposes of applying SFAS 66:

- The seller-lessee sells property improvements or equipment, or both, to a buyer-lessor, and then leases them back while retaining the underlying land.
- The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.
- There exist other provisions or circumstances that allow the seller-lessee to participate in any future profits or the appreciation of the leased property; for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor.

Note that special provisions apply to the sale-leaseback transactions by regulated industries.

If the sale and leaseback is accounted for under the deposit method or as a financing, disclosure is required of—

- The terms of the sale and leaseback, including continuing involvement.
- The aggregate obligation for future minimum lease payments as of the date of the latest balance sheet; the amounts for each of the succeeding five fiscal years; and similar information for the total of minimum sublease rentals to be received in the future under noncancellable subleases.

4.2 Lease Term

The lease term, as defined in amended paragraph 5(f) of SFAS 13, includes all renewal periods during which there will be a loan outstanding from the lessee to the lessor. The Statement also defines the term *penalty* as it is used in the lease term provisions of paragraph 5(f) of SFAS 13 to include foregoing an economic benefit or suffering an economic detriment. SFAS 13 also specifies which factors to consider when determining whether an economic detriment may be incurred and may thereby cause lease terms to be longer than previously contemplated. These modifications of the lease term provisions in SFAS 13 apply to all leases, not just sale and leaseback transactions involving real estate.

4.3 Initial Direct Costs

SFAS 98 amends both SFAS 91 and SFAS 13 to reflect the intent of the FASB regarding the accounting for initial direct costs in direct financing leases. In short, these amendments include the following provisions:

- Both the sum of the minimum lease payments and the unguaranteed residual should be recorded as the gross investment in the lease.
- The difference between the gross investment and the cost of carrying amount, if different, of the leased property should be recorded as unearned income.
- The net investment in the lease consists of the gross investment, plus any unamortized initial direct cost, less unearned income.
- The unearned income and initial direct costs should be amortized to income over the lease term to produce a constant periodic rate of return on the net investment in the lease.

4.4 Effective Date

The Statement is effective for transactions entered into after June 30, 1988. Earlier application to transactions occurring in periods for which annual financial statements have not been issued is encouraged. Regarding the treatment of initial direct costs, that provision will be effective concurrently with the effective date of SFAS 91.

5. SFAS NO. 101

Issued in December 1988 by the Financial Accounting Standards Board, SFAS 101, *Regulated Enterprises—Accounting for the Discontinuance of Application of FASB Statement No. 71*, establishes reporting requirements in general purpose financial statements for enterprises, or parts thereof, that no longer meet the criteria for the application of SFAS 71, *Accounting for the Effects of Certain Types of Regulation.* The Statement applies to public utilities and certain other regulated enterprises that are deregulated, or that experience a change in method of regulation or a change in the competitive environment for the enterprise's regulated services or products.

Essentially, SFAS 101 requires that in such circumstances an enterprise report its assets and liabilities in the same manner as nonregulated enterprises that are not subject to rate-making regulations.

SFAS 101, however, limits any adjustment of the carrying value of plant, equipment, and inventory where those assets are not impaired. Where there is impairment, the write-down to reflect impairment should be to income in the period of change and classified as an extraordinary loss.

The Statement is effective for discontinuations of SFAS 71 occurring in fiscal years ending after December 15, 1988.

6. TECHNICAL BULLETINS

Issued in 1987, Technical Bulletins 87-1, 2, and 3 are discussed in this section.

6.1 Technical Bulletin 87-1

Issued in April 1987, Technical Bulletin 87-1, *Accounting for a Change in Method of Accounting for Certain Post-Retirement Benefits,* states the following: If an employer changes its method of accounting from the cash basis to an accrual basis or from one accrual method to another accrual method for certain post-retirement benefits, the employer may either (a) account for the effect of that change prospectively in the period of change and in future periods or (b) recognize the cumulative effect of the change in net income of the period of the change.

The nature of, justification for, and method of accounting for the change must be disclosed in the financial statements for the period in which the change is made. In addition, certain disclosures of the effects of the change are called for.

The Technical Bulletin is effective for fiscal years beginning after December 15, 1986. Earlier application is permitted. However, restatement of previously issued financial statements is not permitted.

6.2 Technical Bulletin 87-2

Technical Bulletin 87-2, *Computation of a Loss on Abandonment,* was issued in December 1987 to clarify the computation of loss on abandonment as discussed in SFAS 90, *Regulated Enterprises—Accounting for Abandonment and Disallowances of Plant Costs.*

The example in paragraphs 16 to 25 of SFAS 90 is designed to illustrate the computation of a loss on abandonment and the subsequent accounting when the regulator allows the recovery of cost without a return on investment.

The example does not reflect the intent of SFAS 90, which is to amortize the new asset in a manner that would produce a constant return on the unamortized investment in the new asset, and one that is equal to the rate at which net revenues are discounted. A revised illustration is provided in Technical Bulletin 87-2.

In computing deferred income taxes related to the remaining asset when a loss on abandonment is recognized, SFAS 96 requires that the deferred income tax liabilities will be (a) the amount of income taxes that will be payable in future years, based on enacted tax law for those years at the measurement date, as a result of the recovery of the recorded amount of that remaining asset and (b) any additional income taxes that will result from the recovery of a separate asset recognized to reflect the future revenues that are expected to be provided in rates by the regulator when the income taxes in (a) and (b) become payable.

A regulated enterprise that meets the criteria of SFAS 71 should compute a net loss on an abandonment by discounting the after-tax future revenues expected to be allowed by the regulator at an after-tax incremental borrowing rate, then by comparing the result to the recorded net investment in the abandoned plant. If that discounted present value is less than the recorded net investment, a net loss should be recognized. However, the present accounting model generally does not permit display of losses on a net-of-tax basis. As a result, the net loss on an abandonment is grossed up for display purposes.

An appendix in the Technical Bulletin illustrates the application under SFAS 96.

The provisions are effective for fiscal years beginning after December 15, 1987, for all losses on abandonment recognized in accordance with SFAS 90. If SFAS 90 was implemented in a prior fiscal year, existing assets should be adjusted to comply with provisions in Technical Bulletin 87.

6.3 Technical Bulletin 87-3

Accounting for Mortgage Service Fees and Rights, issued in December 1987, provides guidance on how to apply the definition of a normal servicing fee rate to loan sales transactions in the secondary mortgage market. For example—

- Minimum servicing fee rates set by GNMA, FHLMC, and FNMA should be considered normal servicing fee rates for transactions with those organizations.
- The normal servicing fee rate for transactions with these entities should be no less than the entity's specified minimum servicing rate.
- If normal servicing fees are expected to be less than the estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans should be accrued as of the date when the mortgage loans are sold.
- These rates would be applicable where loans are sold to private investors. SFAS 65, *Accounting for Certain Mortgage Banking Activities*, defines a normal servicing fee rate as a rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans (for example, customary in the secondary market by principal market makers).

- The mortgage servicing right represents a contractual relationship between the servicer and the investor in the loan, not between the servicer and the borrower. The cost of mortgage servicing rights may require adjustments as a result of refinancing, depending on the servicer's assumptions in recording the asset. If the refinancing represents a prepayment activity anticipated by the servicer when the servicing asset was recorded, an adjustment would not be necessary. If actual prepayments differ from anticipated prepayments, an adjustment to the servicing asset would be required.

The provisions of Technical Bulletin 87-3 are effective for transactions entered into on or after December 31, 1987. Earlier application is encouraged for transactions occurring in periods for which financial statements have not been issued.

6.4 Technical Bulletin 88-1

Issued by the FASB in December 1988, Technical Bulletin 88-1, *Issues Relating to Accounting for Leases*, deals with several issues of lease accounting.

Time pattern of the physical use of the property in an operating lease. Rental payments, including escalated rents, should be recognized as expense or revenue on a straight-line basis if the rent escalation is in contemplation of the lessee's ultimate physical use of the property, but the lessee takes possession of or controls the leased property at the beginning of the lease term.

On the other hand, if the escalated rentals related to the lessee's gaining access to additional leased property at the time of the escalation, then expenses and revenue should be recognized in proportion to the addition to leased property with the allocation based on the relative fair value of the additional property.

Lease incentives in an operating lease. Incentives paid to, or incurred on behalf of, the lessee by the lessor are an inseparable part of the new lease and should be recognized as reductions of rental expense and rental revenue on a straight-line basis over the term of the lease.

Applicability of leveraged lease accounting to existing assets of the lessor. TB 88-1 reaffirms an earlier pronouncement that leveraged lease accounting, which is applicable to direct financial leases, is appropriate generally when an asset to be leased is acquired by the lessor. In essence, the cost or carrying value, if different, must be the same as the fair value at the inception of the lease.

Money-over-money lease transaction. When an enterprise obtains nonrecourse financing in excess of an asset's cost, based on collateral consisting of the leased asset and future rentals (as in a money-over-money lease), no profit should be recognized at the inception of the lease other than manufacturer's or dealer's profit in a sale-type lease. The nonrecourse financing is treated as a simple borrowing.

Wrap lease transaction. This rather complex transaction deals with situations where a leased asset subject to nonrecourse financing is sold subject to the lease and the existing nonrecourse debt, and is then leased back by the original lessor, who remains the principal lessor under the original lease, hence a wrap lease. Accounting for this transaction is explained in paragraph 22 of Technical Bulletin 88-1, which, essentially, treats the wrap lease as a sale and leaseback.

Effective date. Technical Bulletin 88-1 is effective for transactions entered into after December 31, 1988.

6.5 Technical Bulletin 88-2

Technical Bulletin 88-2, *Definition of a Right of Setoff*, was issued by the FASB in December 1988. It defines a right of setoff as "a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor," and specifies the following conditions (paragraph 2):

- Each of two parties owes the other determinable amounts.
- The reporting party has the right to set off the amount owed with the amount owed by the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable at law.

The Bulletin discusses various pronouncements, such as SFAS 87, which incorporates setoffs in the reporting process. The Bulletin does not alter those treatments.

Effective date. Technical Bulletin 88-2 is effective for transactions entered into after December 31, 1988.

CHAPTER 8
Errors, Irregularities, and Illegal Acts

CHAPTER 8

Errors, Irregularities, and Illegal Acts

1. EXPECTATON GAP

Prodded by criticism from members of Congress, financial writers, judges, and some large CPA firms, in the mid-1980s the Accounting Standards Board (ASB) initiated several projects in response to the public's changing expectations of independent auditors. Many critics charged that a serious gap existed between what the public believed to be an independent auditor's responsibilities and what auditors believed their role to be under professional standards. This gap, shown as Exhibit 8-1, came to be known as the "expectation gap."

This chapter covers the external pressures that led to increasing the auditor's responsibility to detect fraud and illegal acts as well as the profession's response: new Statements on Auditing Standards (SASs) on errors, irregularities, and illegal acts. These new auditing requirements are explained here in detail, together with guidance on how to fulfill these new responsibilities. In addition, the chapter includes which steps an auditor should take when fraud or an illegal act is detected as well as the effect on the audit report.

Exhibit 8-1 *Expectation Gap*

What Standards Require	What Public Wants
■ ------------------------	------------------------ ■

Expectation Gap

2. OUTSIDE PRESSURES TO EXPAND AUDITOR'S RESPONSIBILITY

Beginning early in 1985, the House Energy and Commerce Oversight and Investigations Subcommittee, chaired by John Dingell, held a series of hearings on the accounting profession and the Securities and Exchange Commission's (SEC) oversight and enforcement activities. An outgrowth of these hearings was a bill in May 1986 entitled, "The Financial Fraud Detection and Disclosure Act of 1986" (H.R. 4886), introduced by Representative Ronald Wyden (D-Oregon).

That bill would have required auditors to search for all fraud and to report to regulatory authorities even a suspicion of any illegal or irregular acts. However, reaction to H.R. 4886 from businesses, the accounting profession, the SEC, and the General Accounting Office (GAO) was negative, prompting Representative Wyden to introduce a revised bill (H.R. 5439) in August 1986. Still, H.R. 5439 was not acted on before Congress adjourned, and this and this legislative initiative was not pursued immediately after Congress reconvened because legislators anticipated the profession's voluntary response. Thus, although the Subcommittee continued to hold hearings throughout 1987, it permitted the accounting profession to demonstrate its willingness to expand the auditor's responsibilities to meet public expectations.

The new SASs discussed in this and in subsequent chapters represent the bulk of that response. No doubt, the profession's reception and implementation of the new SASs will have an important effect on whether legislation will be used to regulate public accounting in the future. When release of the expectation gap SASs was announced, Congressman Dingell called the new standards an improvement, but he noted that legislation might still be necessary (*New York Times*, February 10, 1988).

In 1985, the National Commission on Fraudulent Financial Reporting was formed to study the causes of fraudulent financial reporting and to make recommendations either to eliminate or to significantly reduce its occurrence. The Commission's final report, released in October 1987, contained the following recommendations, which pertain to the auditor's responsibility to detect and report fraud:

- Auditing standards related to the responsibility to detect fraud should clearly spell out an affirmative obligation to detect fraud in positive, nondefensive language.
- The standard auditor's report should be revised to better communicate the auditor's role and responsibilities, including those related to fraud detection, and the inherent limitations of an audit.

Early 1988, the ASB approved a new group of SASs that responded to many of the Commission's recommendations. The new SASs covered in this chapter are—

- SAS No. 53 *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* (AICPA *Professional Standards,* Vol. 1, AU§ 316).
- SAS No. 54 *Illegal Acts by Clients,* (AICPA *Professional Standards,* Vol. 1, AU§ 317).

All references to SASs hereinafter shall include Professional Standards AU paragraph citations.

3. DEFINITIONS OF ERRORS, IRREGULARITIES, AND ILLEGAL ACTS

Errors, irregularities, and *illegal acts* are defined in SASs 53 and 54 as follows:

> *Errors.* The term refers to *unintentional* misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—
>
> - Mistakes in gathering or processing accounting data from which financial statements are prepared.
> - Incorrect accounting estimates arising from oversight or misinterpretation of facts.
> - Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.
>
> *Irregularities.* The term refers to *intentional* misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render misleading financial statements, sometimes called management fraud, and misappropriation of assets, sometimes called defalcation. Irregularities may involve such acts as the following:
>
> - Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.
> - Misrepresentation or intentional omission of events, transactions, or other significant information.
> - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
>
> *Illegal Acts.* The term refers to violations of laws or government regula-

tions. For purposes of the SASs, illegal acts are classified in two broad categories:

- Illegal acts that have a direct and material effect on the determination of financial statement amounts, except for the disclosure of contingencies.
- Other illegal acts that have an indirect effect on the financial statements. This effect normally is the result of the need to disclose a contingency caused by allegation or determination of illegality.

Exhibit 8-2 *Errors, Irregularities, Illegal Acts—Definitions*

Error—Unintentional Misstatement
Irregularity—Intentional Misstatement
Illegal Act—Violation of law or government regulation

Illegal acts by clients are those acts attributable to the entity whose financial statements are being audited. Illegal acts by clients do *not* include personal misconduct unrelated to business activities by the entity's personnel.

The key difference that distinguishes *errors* and *irregularities* is whether the underlying cause of the misstatement in the financial statements is *intentional* or *unintentional.* SAS 53 does not directly state this but implies that a material error should be easier to detect than a material irregularity. Although SAS 53 covers the responsibility to detect both material errors and irregularities, the focus clearly is on irregularities, and the approach the auditor should take to detect them.

4. THE AUDITOR'S RESPONSIBILITY FOR DETECTION

SAS 53 on fraud detection both expands and clarifies the auditor's responsibility to detect material irregularities. While SAS 54 on illegal acts essentially retains the present responsibilities described in SAS No. 17 *Illegal Acts by Clients,* it also defines certain illegal acts as irregularities, thereby increasing the auditor's detection and reporting responsibilities.

4.1 Errors and Irregularities

The auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. The auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of *reasonable* assurance, the auditor is not an insurer, and the audit report does not guarantee that no material errors and irregularities exist.

SAS 53 supersedes SAS 16, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities* issued in 1977, which required the auditor to plan the audit to search for material errors and irregularities. In contrast, SAS 53 requires the auditor to design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

Is there a distinction between *plan to search* and *design to provide reasonable assurance of detecting*? The difference may be subtle, but the ASB definitely had a message for auditors: Be more sensitive to the *possibility* of material irregularities in every audit. Clearly, the Board expects auditors to carefully consider the risk in a client's specific circumstances that may lead to material misstatement because of intentional misconduct by senior management or employees.

The difference between SAS 16 and 53 is exemplified by the attitude that the auditor should have concerning the possibility of dishonest management. Most auditors believed that SAS 16 entitled them to *assume* that management was honest, unless information came to their attention that specifically contradicted that assumption.

SAS 53 discards that comfortable notion. Auditors no longer can assume that management is honest or dishonest. At the start of the audit, the auditor now should take a cold, hard look at the possibility of management misrepresentation and reexamine that likelihood as the audit progresses. Another difference between SASs 53 and 16 is that SAS 53 expresses the auditor's responsibility in a much more affirmative and positive fashion. For instance, SAS 16 stressed the inherent limitations of an audit, which make it impossible for an auditor to provide absolute assurance of detecting even material frauds. Although SAS 53 continues to acknowledge that forgery or collusion may result in a failure to detect a material irregularity, it focuses more on what the auditor should do rather than on elements that preclude infallibility.

Because auditors cannot guarantee the detection of material errors and irregularities, they usually have included a disclaimer of responsibility in their engagement letters. The typical engagement letter in the past has contained a caveat stating that an audit is not specifically designed, and cannot be relied upon, to detect irregularities although their discovery may result.

Apparently, some auditors believed that the language of the engagement letter was an accurate description of their responsibility. SAS 53 clearly invalidates this misguided belief. An audit should be designed to provide reasonable assurance of detecting material irregularities.

4.2 Illegal Acts

Closely related to the responsibility to detect irregularities is the responsibility to detect illegal acts. According to SAS 54, the auditor should consider the possibility of illegal acts by the client when planning the audit. SAS 54 supersedes SAS 17, which was issued with SAS 16 in January 1977.

The responsibilities to detect illegal acts vary, depending on the type of illegal act. The auditor's responsibility to detect misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts (except the disclosure of contingencies) is the same as that for errors and irregularities.

Exhibit 8-3 *Differences Between Old and New Standards on Errors and Irregularities*

	Old	*New*
Statement	SAS 16	SAS 53
Responsibility for detecting errors and irregularities	Plan audit to search for material errors and irregularities	Design audit to provide reasonable assurance that material misstatements will be detected
Internal communication of irregularities	To one level above	To audit committee
Acknowledgement of limits	Inherent limitations of the audit	Characteristics of irregularities may result in failure to detect

With respect to other illegal acts, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention suggesting that such acts may have occurred, the auditor should apply audit procedures specifically designed

Exhibit 8-4 *Differences Between Old and New Standards on Illegal Acts*

	Old	*New*
Statement	SAS 17	SAS 54
Responsibility for detecting illegal acts	Not responsible for detecting any illegal acts	Responsible for detecting illegal acts with direct and material effect Indirect effect—remain aware of possibility
Internal communication of illegal acts	To appropriate level of authority	To audit committee

to ascertain whether or not an illegal act has occurred. However, note that an audit conducted in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Some observers have noted significant parallels between SASs 53 and 54 and have questioned the need for two separate statements. Why not have one SAS that deals with the responsibilities to detect and report errors, irregularities, and illegal acts?

The main reason for two separate SASs is that the ASB wanted to make a sharp distinction between the auditor's responsibility to detect irregularities versus illegal acts. The ASB believed that it simply is not feasible to design the audit to provide reasonable reasonable assurance of detecting all illegal acts that could have a material effect on the financial statements. Businesses in the United States are subject to a host of laws and regulations which, if violated, invoke consequences very material to the financial statements. For example, violations of laws related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, price fixing, and other antitrust provisions can all have very material effects on financial statements. However, usually an auditor is not equipped to spot, by training or experience, violations of such laws and regulations. As a practical matter, an auditor would have little, if any, chance of detecting such violations unless he was informed by the client or its attorney, or if there were evidence of a government agency investigation or enforcement proceeding in the corporate minutes or correspondence made available.

Exhibit 8-5 *Detection Responsibility Errors, Irregularities, and Illegal Acts*

Yes	*No*
Material Errors	
Material Irregularities	
Illegal Acts with Direct and Material Effect on Statements	Other Illegal Acts (Contingent Liabilities)

For these reasons, the auditor does not plan the audit to include audit procedures specifically designed to detect illegal acts. If procedures designed primarily for other purposes bring possible illegal acts to the auditor's attention, then the auditor has some additional responsibilities that are related to evaluating audit test results, which are discussed later in this chapter. However, as a general matter, the possibility of illegal acts has no effect on audit planning.

There is one very important exception to this generalization. For illegal acts that have both a direct and a material effect on the determination of financial statement line item amounts, the auditor has exactly the same responsibilities outlined for material irregularities. In other words, the audit should be designed to provide reasonable assurance of detecting illegal acts that have a direct and a material effect on line item amounts in financial statements. For example, assume that a client obtains a government contract requiring compliance with certain specified laws and regulations for revenue to be earned under the contract and that the amount of the revenue recorded in the current period is material. The auditor would need to apply audit procedures to test compliance with the specified laws and regulations because compliance is necessary for the revenue to be earned and recorded.

In other words, compliance with the specific laws and regulations has a *direct* effect on the determination of recorded revenue. However, there are other laws and regulations which, if violated by the client, might cause the government to suspend the contract, and no further revenue would be earned under that or similar contracts. For example, a contract may have a standard provision stating that the contractor is an equal opportunity employer. These laws and regulations have an indirect effect on the financial statements, and their effect is a contingency that may need to be disclosed.

The auditor has no responsibility to design the audit to detect violations of laws and regulations that could have a material effect on the financial statements only through the need to disclose a contingency. In other words, laws and regulations that have an indirect effect on financial statements are normally outside the auditor's detection responsibility.

5. PERFORMANCE GUIDANCE—IRREGULARITIES

In general, the detection responsibilities imposed by SAS 53 increase the auditor's responsibility. The primary change in practice, however, is a specific requirement to review any client characteristics that (a) might increase the risk of material misstatements and (b) should heighten the auditor's skepticism (see Exhibit 8-6).

Exhibit 8-6 *New Requirements by Audit Phase*

Audit Planning	
Consider risk factors (and effects of internal control structure at—	
• Overall financial statement level	Exhibit 8-7.
• Account balance or transaction level.	Exhibit 8-9.
Assess likelihood of material misstatement.	Exhibit 8-8.
Consider assessment in general audit planning decisions.	Staffing, supervision, overall audit strategy, degree of skepticism.
Consider assessment in planning audit programs for particular account balances and transaction classes.	May require more persuasive evidence.
Plan to make specific inquiries of management concerning compliance with laws, etc.	
Evaluation of Results of Audit Procedures	
Consider quantitative and qualitative aspects of audit differences and other adverse conditions to detect potential irregularities.	Exhibit 8-11.

Exhibit 8-6 (cont.)

Reassess risk of material misstatement.	
Reconsider scope of audit procedures applied.	
Apply additional procedures to obtain more information concerning potential irregularities.	
Note any potential illegal acts that come to the auditor's attention while performing audit procedures.	Exhibit 8-12.
Apply additional procedures to obtain more information concerning potential illegal acts.	
Communications (Internal and External)	
Consider effect on financial statements (and on other aspects of the audit).	
Communicate with audit committee.	

5.1 Assessment of Likelihood of Material Misstatement Made During Audit Planning

Client characteristics that trigger questions about the likelihood of material misstatement are sometimes called *red flags*. Examples of red flags that are specifically identified in SAS 53 are–

- Operating and financing decisions are dominated by a single person.
- The client's organizational structure is decentralized and lacks adequate monitoring.
- There are many contentious or difficult accounting issues.

The auditor is supposed to consider the effect of the red flags on the overall audit strategy and on the expected conduct and scope of the audit. Note that the auditor makes an overall judgment; the mere presence of one or two red flags might not be considered important in particular circumstances. For example, in determining which red flags are significant, the auditor's judgment may be influenced by the size, complexity, and ownership characteristics of the client company.

In addition to obtaining information about client characteristics, the auditor should consider the red flags in conjunction with information about the internal control structure to assess the risk of management misrepresentation. Understanding the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements.

The auditor's overall judgment about the level of risk in an engagement should be considered in developing the audit plan. The assessment of risk could affect decisions about engagement staffing, the extent of supervision, overall audit stragegy, and the necessary degree of professional skepticism. In critical or key audit areas identified as a result of this risk assessment, the auditor may require more persuasive evidence.

Specifically, the auditor should consider those factors that influence audit risk at the entity or financial statement level, and at the account balance or class-of-transactions level. For example, at the entity (overall) level, the auditor should—

- Assess the risk of material misstatements during audit planning by considering the characteristics of management, the entity and the industry, and the engagement (see Exhibit 8-7).
- Consider whether or not the client's internal control structure affects the risk assessment.
- Assess the likelihood of management misrepresentation (see Exhibit 8-8).
- Consider this risk assessment when making initial audit planning decisions concerning staffing, supervision, audit procedures in critical audit areas, and the degree of professional skepticism to be exercised.

In planning audit programs for particular account balances or transaction classes, the auditor should consider factors that influence the inherent risk and control risk for the balance or class (see Exhibit 8-9).

5.1.1 Audit Documentation

SAS 53 does not specifically require the use of a generalized form to document the auditor's assessment of the risk of material misstatement. However, SAS 53 does specifically require the auditor to make the assessment; therefore, it would be prudent to document the pertinent considerations. Exhibit 8-10 presents an example of a general risk questionnaire.

Exhibit 8-7 *Risk Factors at Entity or Financial Statement Level*

Management Characteristics

Domination of operating or financing decisions by a single person.

Unduly aggressive attitude toward financial reporting.

High turnover (particularly of senior accounting personnel).

Undue emphasis on meeting earnings projections.

Poor reputation in the business community.

Operating and Industry Characteristics

Inadequate or inconsistent profitability relative to industry.

Operating results highly sensitive to economic factors—inflation, interest rates, etc.

Rapid rate of change in industry.

Decentralized organization with inadequate monitoring.

Indicators of substantial doubt about the entity's ability to continue as a going concern.

Engagement Characteristics

Many contentious or difficult accounting issues.

Frequent and significant difficult-to-audit transactions or balances.

Significant nature, cause, or amount of known and likely misstatements detected in prior audits.

New client with no prior audit history or insufficient information available from predecessor.

Exhibit 8-8 *Assessment of Likelihood of Management Misrepresentation*

Indications	*Examples*
Are there known circumstances that may indicate a predisposition to distort financial statements?	Frequent disputes about aggressive application of accounting principles. Evasive responses to audit inquiries. Excessive emphasis on meeting quantified targets.
Are there indications that management has not established policies and procedures that provide reasonable assurance of reliable accounting estimates?	Personnel developing estimates appear to lack necessary knowledge and experience. Supervisors of these personnel appear careless or are also inexperienced.

Exhibit 8-8 (cont.)

Indications	*Examples*
	There is a history of unreliable or unreasonable estimates.
Are there conditions that indicate lack of control of activities?	Constant crisis conditions in operating or accounting areas.
	Disorganized work areas.
	Frequent or excessive backorders, shortages, or delays.
Are there indications of a lack of control over computer processing?	Lack of control over access to applications that initiate or control asset movement (e.g., a demand-deposit application in a bank).
	High levels of processing errors.
	Unusual delays in providing processing results.
Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets?	Employees in key positions not investigated before hiring or not bonded.
	Unauthorized personnel having ready access to data or assets.

Exhibit 8-9 *Risk Factors at Account Balance or Class of Transactions Level*

- Effect of risk factors identified at the financial statement level.
- Complexity and contentiousness of accounting issues.
- Frequency or significance of difficult-to-audit transactions.
- Nature, cause, and amount of known and likely misstatements detected in the balance or class in prior examinations.
- Susceptibility of related assets to misappropriation.
- Competence and experience of personnel assigned to processing data that affects the balance or class.
- Extent of judgment involved in determining the total balance or class.
- Size and volume of individual items comprising the balance or class.
- Complexity of calculations affecting the balance or class.

Exhibit 8-10

GENERAL RISK QUESTIONNAIRE

Client ______________________

Prepared by ______________________

Date ______________________

Approved by ______________________

Date ______________________

Instructions
This form documents our consideration of the overall level of risk on the engagement. Assessing the engagement risk requires judgment. The particular matters to be considered and the significance of each should be determined based on the circumstances of the engagement. *Not all the matters listed will be important in a particular engagement.*

If the conditions or circumstances in this engagement indicate *higher or lower* risk than normal, describe them in the column on the right. If other conditions or circumstances seem important, add them at the end. After all relevant factors are considered, the auditor should make an overall assessment of engagement risk and indicate its effect on the audit plan.

Factor	Indicator: Lower	Indicator: Higher	Comment or description
Management operating style	Effective oversight group	Domination of decisions by single person	
Management attitude on financial reporting	Conservative	Aggressive	
Management turnover, including senior accounting personnel	Nominal	High	
Emphasis on meeting earnings projections	Little	Very high	
Reputation in business community	Honest	Credible allegation of improper conduct	
Profitability relative to industry	*Adequate and consistent*	*Inadequate or inconsistent*	
Sensitivity of operations to interest rate changes or inflation	Relatively insensitive	Very sensitive	
Rate of change in industry	Stable	Rapid	
Status of industry	Healthy	Distressed	
Organization of operations	Centralized	Decentralized	
Indicators of going-concern problems	No serious indications	Substantial doubt could exist	
Contentious accounting issues	None	Many	
Difficult-to-audit transactions or balances	Few	Many	
Misstatements detected in prior audits	Few and immaterial	Greater than preliminary judgment about materiality	
Relationship with client	Recurring engagement	New engagement	

Consideration of the risk factors identified above has caused the following modifications of the audit plan in the following critical audit areas:

____

____

____

The primary advantage of generalized materials is to help ensure that workpapers developed in the field will adequately support a conclusion that the financial statements are not materially affected by an irregularity when an unqualified opinion is expressed.

Thus, by using a generalized form, a CPA firm can take steps in advance to help ensure that important matters are adequately documented. The matters that are documented in the general risk questionnaire in Exhibit 8-10 are specific consideration of management, the entity, industry, and engagement characteristics to assess the probability of misstatement, including the likelihood of management misrepresentations.

Note that the form provides space to add risk factors. A variety of factors may point to a higher than normal risk of material misstatement at the engagement level: competitive pressures; litigation closely related to survival; significant related-party transactions; management compensation arrangements that depend heavily on earnings or stock performance; and discretionary accounting changes that significantly increase income.

A disadvantage of using this type of documentation is that it may create a burden to demonstrate that appropriate modifications were made in planning the audit when risk is higher than normal. Also, the use of this type of form requires considerable judgment; it cannot be completed by lower-level staff.

5.2 Auditing in a High-Risk Environment

An audit of financial statements in accordance with generally accepted auditing standards should always be planned and performed with an attitude of *professional skepticism*. The auditor cannot assume either honesty or dishonesty on management's part. The auditor should recognize the increased importance of management integrity indicators when planning and performing audit procedures for assertions that are difficult to substantiate. (For example, completeness of revenue is usually difficult to substantiate for a casino or a charity.)

Higher than normal risk of material misstatement usually requires more experienced personnel or more extensive supervision, and the auditor may attempt to obtain more persuasive evidence. If the auditor has concluded that there is a significant risk of material misrepresentation by management, the auditor should modify auditing procedures accordingly. For example, the auditor may—

- Identify specific transactions involving senior management and confirm the details with reliable external parties.

- Review in detail all material accounting entries prepared or approved by senior management.
- Consider whether accounting principles that are generally accepted are being applied in inappropriate circumstances to create a distortion of earnings. (For example, misuse of the percentage-of-completion method to inflate earnings when the completed-contract approach would be more appropriate for profit recognition.)
- Require more or different evidence to support material transactions. (For example, apply additional procedures to substantiate the absence of a right-of-return agreement for recorded sales.)

5.3 Reassessment of Likelihood of Material Misstatement in Applying Audit Procedures

SAS 53 indicates that the auditor's assessment of the risk of material errors and irregularities does not end with planning the audit. The initial results of audit tests may warrant reassessment as the audit progresses. This is particularly appropriate when audit test results differ significantly from the auditor's expectations, or when the auditor is unable to obtain satisfactory explanations for audit differences. For example, confirmation requests may yield fewer responses than expected, or they may disclose significant differences from recorded amounts. Or, analytical procedures may disclose significant differences from expectations.

Under SAS 53, if the application of audit procedures detects conditions or circumstances that adversely differ from the auditor's expectations, the auditor should reconsider the scope of planned audit procedures as well as the assessment of the risk of material misstatement made during audit planning (see Exhibit 8-11).

In evaluating audit test results, the auditor should consider the significance of detected audit differences. An *audit difference* is a discrepancy between the accounting records and the underlying facts and circumstances established by the auditor's procedures. For example, there may be a difference between the physical count of an asset, such as securities on hand, and the amount recorded in the general ledger. The auditor should consider the quantitative and qualitative aspects of audit differences and determine if they are indicative of an error or irregularity. Note that the detection of an irregularity has implications that go beyond both the monetary effect of the particular difference and the projected

Exhibit 8-11 *Adverse Conditions or Circumstances Dectected by Audit Procedures*

- Analytical procedures disclose significant differences from expectations.
- Differences between reconciliations of a control account and subsidiary records or between an asset count (i.e., securities in a safe deposit box) and a general ledger account are not appropriately investigated and corrected on a timly basis.
- Confirmation requests disclose significant differences or yield fewer responses than expected.
- Transactions selected for testing are not supported by proper documentation or appropriately authorized.
- Supporting records or files that should be readily available are not promptly produced when requested.
- Errors are detected in audit tests that apparently were known to client personnel but were not voluntarily disclosed to the auditor.

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effect of the detected amount. For instance, the auditor might consider the likelihood of similar items' going undetected or of irregularities in other areas.

If the auditor determines that an audit difference is, or may be, an irregularity, the next step will depend on the potential materiality of the matter. If the auditor has determined that the effect on the financial statements could not be material, the auditor should refer the matter to management that is at least one level above those involved. For example, theft from a small petty cash fund usually does not affect other aspects of the audit because the petty cash custodian is usually a low-level employee and the amount is not material. However, the auditor should be satisfied that in view of the position of the likely perpetrator, the irregularity (a) has no implications for other aspects of the audit or (b) those implications have been adequately considered.

If the auditor has determined that an audit difference is, or may be, an irregularity, and has determined that the effect could be material or has been unable to evaluate potential materiality, the auditor should—

- Consider the implications for other aspects of the audit.
- Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved.
- Attempt to obtain sufficient, competent, and evidential matter to determine if in fact material irregularities exist and, if so, their effect.

- If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law, such as possible prosecution of the perpetrator, insurance coverage, and the necessity of timely disclosure of the incident. The legal ramifications of the situation make early involvement of the client's legal counsel advisable.

6. PERFORMANCE GUIDANCE—ILLEGAL ACTS (INDIRECT EFFECT ON FINANCIAL STATEMENTS)

Audit procedures applied for the purpose of forming an opinion on the financial statements may bring illegal acts to the auditor's attention. Such procedures include reading minutes and contracts; inquiring of the client's management and legal counsel about litigation, claims, and assessments; obtaining a client representation letter; and performing substantive tests of details of transactions or balances. For example, illegal acts may be indicated by unauthorized transactions, improperly recorded transactions, and large payments for unspecified services to consultants or affiliates.

In addition, the auditor should make specific inquiries of management concerning the client's compliance with laws and regulations as well as the client's policies regarding the prevention of illegal acts (see Exhibit 8-12).

If the auditor becomes aware of specific information that provides evidence concerning a possible illegal act, then the auditor should inquire of management at a level above those involved, if possible. Generally, the information to be obtained concerns the nature of the act and the circumstances surrounding it. If management fails to provide satisfactory information, the auditor should consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. If necessary, the auditor should also apply additional procedures to obtain a better understanding of the nature of the acts, including the following measures:

- Examine supporting documents, such as invoices, cancelled checks, and agreements, and compare them with accounting records.
- Confirm significant information concerning the matter with the other party to the transaction or with such intermediaries as banks or lawyers.
- Determine whether the transaction has been properly authorized.

- Consider whether other similar transactions or events may have occurred and apply procedures to identify them.

If the auditor concludes, based on information and, if necessary, consultation with legal counsel, that an illegal act has occurred or is likely to have occurred, the auditor should consider the implications for other aspects of the audit. Is the illegal act indicative of a significant deficiency in the internal control structure? Is the level of management or employees involved indicative of a management integrity problem? Indications of lack of management integrity mean an increased risk of material misstatement of the financial statements. In the extreme, if there is substantial lack of management integrity at the top level, the audit usually cannot be completed.

Exhibit 8-12 *Specific Information Providing Evidence Concerning Possible Illegal Acts*

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets.
- Investigation by a government agency, an enforcement proceeding, or payment of fines or penalties.
- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor.
- Large payments for unspecified services to consultants, affiliates, or employees.
- Sales commissions or agents' fees that appear excessive in relation either to those normally paid by the client or to the services actually received.
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions.
- Unexplained payments made to government officials or employees.
- Failure to file tax returns or to pay government duties or similar fees that arecommon to the entity's industry or the nature of its business.

6.1 Audit Documentation

The general risk questionnaire discussed in the previous section (Exhibit 8-10) does not include information on, or an assessment related to, illegal acts because the auditor's responsibility for detection of irregularities differs from its responsibility for illegal acts, except for those illegal acts that are equivalent to irregularities.

If an illegal act has a direct and material effect on the determination of a line item amount, the auditor's responsibility is the same as that for irregularities. These types of illegal acts are encompassed by the assessment of the risk of material misstatement determined in the general risk questionnaire. The possibility of other illegal acts does not have to be considered in developing the audit plan. The procedures that would bring such illegal acts to the auditor's attention, such as reading minutes and contracts and confirmation with legal counsel, are a normal part of an audit of financial statements. The nature, timing, and extent of these procedures need not be affected by the possibility of illegal acts.

7. COMMUNICATIONS CONCERNING IRREGULARITIES AND ILLEGAL ACTS

When irregularities or illegal acts are detected, they should be communicated to senior management and to the board of directors or its audit committee. Since both SASs impose essentially the same internal communications requirements for irregularities and illegal acts, they will be discussed together in this section.

The auditor should communicate the following matters either to the audit committee or to those with equivalent authority and responsibility:

- Any irregularities or illegal acts involving senior management.
- Any other irregularities or illegal acts of which the auditor becomes aware during the audit, unless those irregularities or acts are clearly inconsequential.

"*Clearly inconsequential*" is an amount significantly below the border of material and immaterial. In other words, it is a *de minimus* amount so obviously immaterial that its insignificance is unquestionable. An irregularity or illegal act involving senior management, however, is *never* inconseqential and should be communicated directly to the audit committee or its equivalent.

In contrast to SAS No. 61, *Communication With Audit Committees*, the communications for irregularities and illegal acts are required in *all* audits. Even if the entity does not have an audit committee, these communications must be made. The only difference is that the communication is made to the equivalent of an audit committee. The equivalent of an audit committee is either a group or a person with equivalent responsibility for oversight of financial reporting, such as the board of directors, the board of trustees, or the owner in an owner-managed entity.

Irregularities that are individually immaterial may be reported to the audit committee on an aggregate basis. The auditor may reach an understanding with the audit committee on the nature and amount of reportable irregularities and illegal acts.

Both SASs 53 and 54 acknowledge that the disclosure of irregularities or illegal acts to parties other than the client's senior management and its audit committee is not ordinarily part of the auditor's responsibility. In fact, disclosure would be precluded by the auditor's ethical responsibility, unless the matter affects the audit opinion on the financial statements. The auditor should recognize, however, that a duty to notify parties other than the client may exist in the following circumstances:

- Disclosure by the entity to the SEC when the auditor has withdrawn or been dismissed and an auditor change is reported on Form 8–K
- Disclosure to a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AU 315)
- Disclosure to a court in response to a subpoena
- Disclosure to a funding or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency.

Also, some states have laws that affect the auditor's responsibility to communicate with others. For example, many states have statutes on maintaining client confidentiality, but in others, it is a criminal offense not to report a felony to the proper authorities. SASs 53 and 54 do not deal with state statutes because it is a legal matter involving too many variations and interpretations. Auditors should seek the advice of legal counsel when such a situation arises.

8. EFFECTS OF IRREGULARITIES OR ILLEGAL ACTS ON THE AUDIT REPORT

If the auditor concludes that an illegal act or an irregularity has a material effect on the financial statements, and that the act has not been properly accounted for or disclosed, the auditor should express a qualified or adverse opinion on the financial statements taken as a whole.

If the auditor is precluded by the client from obtaining sufficient competent evidential matter to evaluate (a) whether a possible illegal act is, in fact, illegal or material to the financial statements or (b) whether a possible irregularity materially affects the financial statements, the auditor generally should disclaim an opinion on the financial statements taken as a whole.

If the client refuses to accept the auditor's report as appropriately modified for a material irregularity or illegal act, the auditor should withdraw from the engagement. Whether or not the auditor concludes that withdrawal from the engagement is appropriate in other circumstances depends on the diligence and cooperation of senior management and the board of directors in investigating the circumstances and taking appropriate remedial action.

9. IMPLEMENTATION ISSUES

9.1 Engagement Letters

The typical engagement letter in the past has contained a caveat stating that an audit is not specifically designed, and cannot be relied upon, to detect irregularities although their discovery may result. However, SAS 53 clearly states that an audit should be designed to provide reasonable assurance of detecting material irregularities.

Does this mean that the wording of the typical engagement letter should be modified? Probably. However, the ASB did not take a position on this issue because an engagement letter is a business device for the auditor's protection, not a professional requirement. Engagement letters should be revised along the lines of the new description of an audit in the scope paragraph of the new standard report presented in SAS No. 58, *Reports on Audited Financial Statements*, which is covered in Chapter 11.

9.2 Management Representation Letter

Does the professional skepticism mandated by SAS 53 imply that a management representation letter is worthless? Certainly not. Obtaining certain representations from management is required by SAS No. 19, *Client Representations*, and SASs 53 and 54 do not change this requirement.

If the auditor exercises professional skepticism in planning and performing the audit and in evaluating audit test results, the worth of management's representations is enhanced rather than reduced. Management's representation letter is signed near the conclusion of the audit, and, by that time, the auditor should have resolved any significant doubts about management's integrity. Moreover, obtaining management's representations has never been a substitute for applying audit procedures.

The typical representation letter ordinarily obtained under SAS 19 already includes appropriate representations concerning the absence of illegal acts and irregularities and need not be changed for the new SASs.

9.3 Legal Representation Letter

Should the written representations ordinarily obtained from the client's lawyer be modified because of SASs 53 or 54? For example, should the attorney be asked to provide comfort on the absence of illegal acts? No. The lawyer doesn't conduct a legal audit and would not be able to provide such broad assurance on the legality of the client's conduct. The ordinary legal representation letter requires no modification.

In some cases, however, the client's attorney may be asked to provide an opinion on the legality of a *specific* matter. Whether or not such documentation is needed is left to the auditor's professional judgment. However, such documentation usually is a separate matter and is not part of the ordinary legal representation letter.

9.4 Materiality

Does the concept of an illegal act with a direct and material effect on a financial statement line item mean that materiality is judged in relation to the individual amount? Definitely not. Materiality should be evaluated in relation to the financial statements taken as a whole as explained in SAS No. 47, *Audit Risk and Materiality In Conducting an Audit.* The ASB did not intend to change any of the guidance contained in that Statement.

9.5 Compilation and Review Services

What is the impact of SASs 53 and 54 on compilation and review services? None. Statements on Auditing Standards do not apply to compilation and review engagements.

9.6 Effective Dates

SASs 53 and 54 are effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the Statements is also permitted.

9.7 Limitations

Some auditors are concerned that the new Statements may mean that the auditor is now responsible for detecting *all* types of irregularities, if material. This is not true. According to SAS 53, because of the characteristics of some irregularities, such as forgery and collusion, a properly designed and executed audit may not detect a material irregularity.

9.8 Working Papers

SASs 53 and 54 do not have specific documentation requirements. SAS No. 41, *Working Papers,* requires auditors to document both procedures performed and conclusions reached in audit engagements. Based on this responsibility, in conjunction with the responsibilities of SAS 53, auditors are well advised to include documentation of the risk factors as well as the risk assessment of material misstatements. The form and content of such documentation is a matter of auditor judgment.

9.9 Owner-Manager Fraud or Illegal Act

If an irregularity or illegal act committed by the owner-manager is discovered, the auditor should discuss the matter with the owner-manager to be certain that the situation is fully understood. The perpetration of an irregularity or illegal act at such a high level in the organization usually has a pervasive effect on the audit and may cause the auditor to conclude that withdrawal from the engagement is appropriate.

SAS 53 (AU 316.29) and SAS 54 (AU 317.23) indicate that the disclosure of irregularities or illegal acts to parties outside the client is ordinarily outside the scope of the auditor's responsibilities, and may even be precluded unless the matter affects the audit opinion on the financial statements. State laws have different requirements, ranging from laws requiring client confidentiality to laws that make it a criminal offense to fail to report a felony. The auditor should consult with legal counsel before discussing the matter with others outside the client organization.

9.10 Form of Communication

How should auditors communicate irregularities to the audit committee or its equivalent? SAS 53 does not require the auditor to communicate the irregularity directly to the audit committee. The auditor must be assured that the audit committee is informed of the irregularities identified. If the auditor does communicate directly to the audit committee, that communication can be either oral or written. The auditor should document oral communications in the audit working papers.

9.11 Audit Consideration of Laws and Regulations

The auditor's objective is not to assess the legality or illegality of an act. Instead, the auditor is required to assess whether the financial statements are free of material misstatement. For example, the client may not have filed tax returns or paid taxes, a violation of an act that directly affects the tax accrual on the financial statements. The omission may result in significant financial penalties, which need to be reflected in the financial statements. The auditor should be concerned with achieving audit objectives related to the existence, completeness, and valuation of the tax accrual and related items, but not directly with compliance with tax laws and regulations. However, the determination of a proper accrual for the tax liability requires an assessment of compliance because of the relation of compliance to achieving audit objectives.

9.12 Effects of an Illegal Act on the Financial Statements

The auditor should consider the effects of an illegal act on the amounts presented in the financial statements, including contingent monetary effects such as fines, penalties, and damages. The auditor should evaluate the adequacy of the financial statement disclosure of the potential effects on the entity's operations. If the auditor cannot assess the effects of the illegal act on the financial statements, he or she should consider the guidance regarding uncertainties provided in SAS 58.

10. SUMMARY

SAS 53 on errors and irregularities expands and clarifies the auditor's responsibility to detect material irregularities. It requires specific consideration of the risk of material misrepresenttion by management in audit planning and expands what it means to exercise professional skepticism in planning and performing an audit.

SAS 54 on illegal acts essentially retains the present responsibility as originally described in SAS 17, but defines certain illegal acts as irregularities, which increases the auditor's detection and reporting responsibilities. The requirements imposed by these two SASs are described in this chapter.

Exhibit 8-13 presents a flowchart of the process of the auditor's consideration of errors, irregularities, and illegal acts in the audit.

Exhibit 8-13

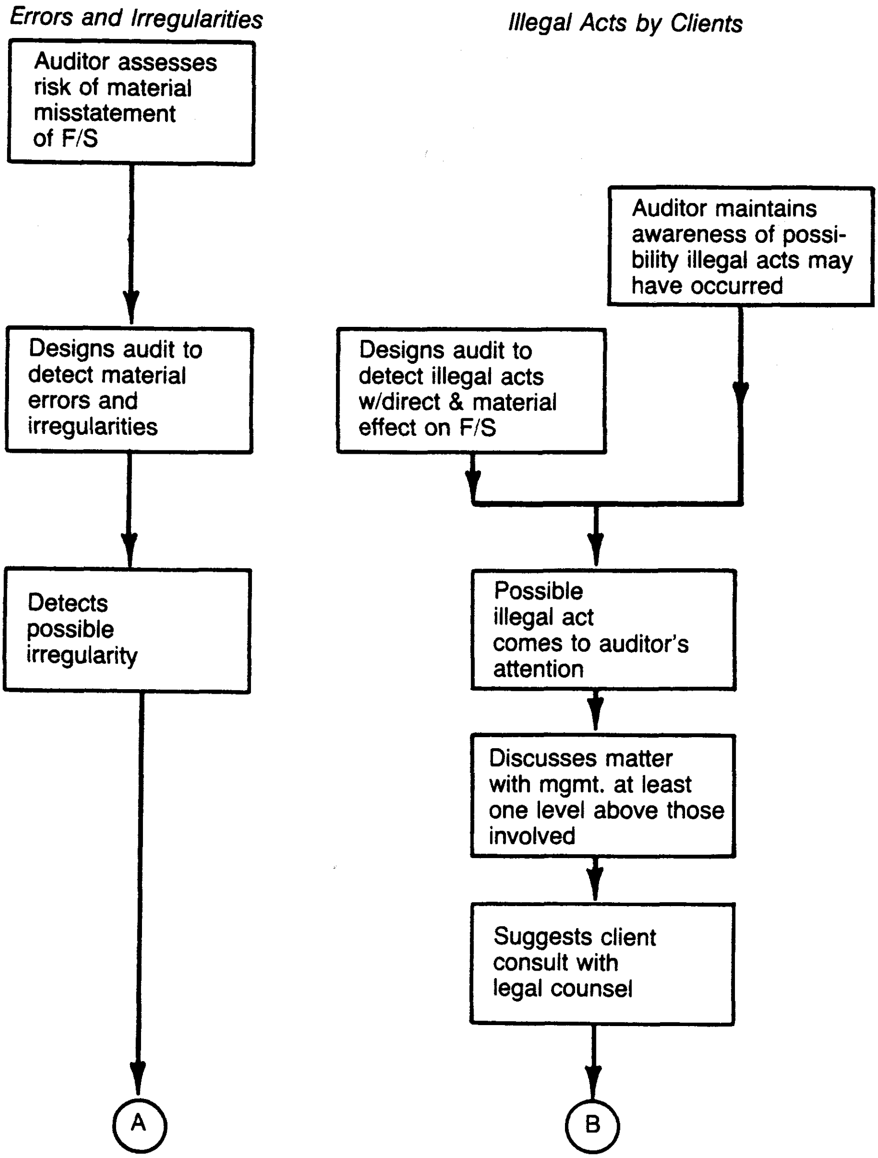

Errors and Irregularities
Illegal Acts by Clients
Auditor assesses risk of material misstatement of F/S
Designs audit to detect material errors and irregularities
Detects possible irregularity
A
Auditor maintains awareness of possibility illegal acts may have occurred
Designs audit to detect illegal acts w/direct & material effect on F/S
Possible illegal act comes to auditor's attention
Discusses matter with mgmt. at least one level above those involved
Suggests client consult with legal counsel
B

Exhibit 8-13 (cont.)

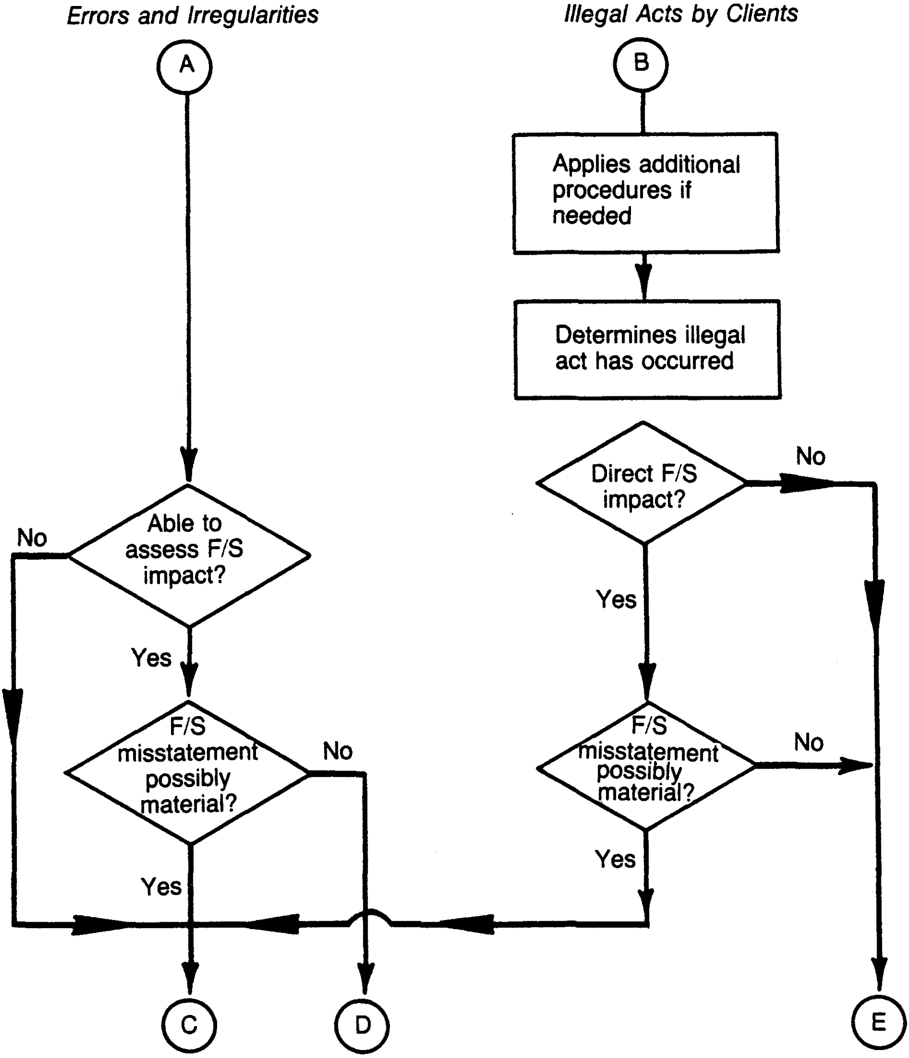


Exhibit 8-13 (cont.)

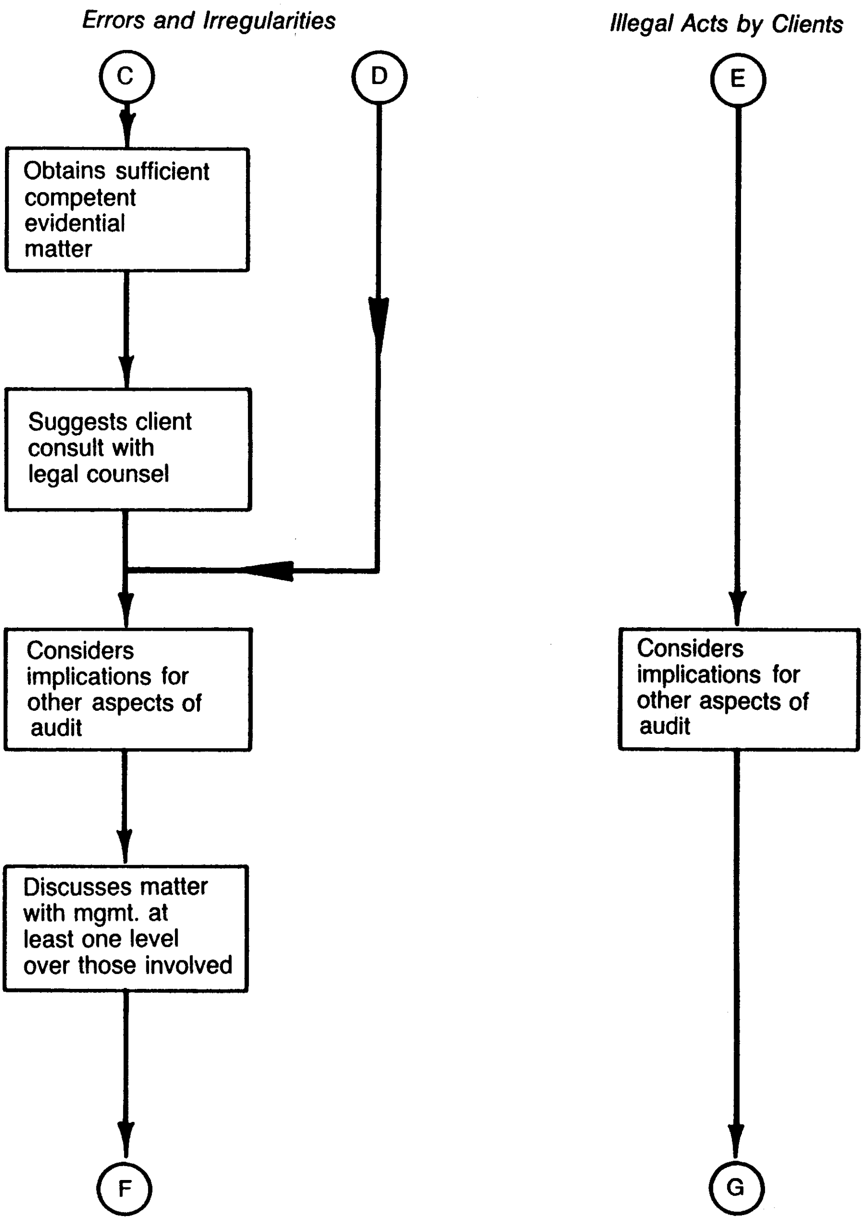
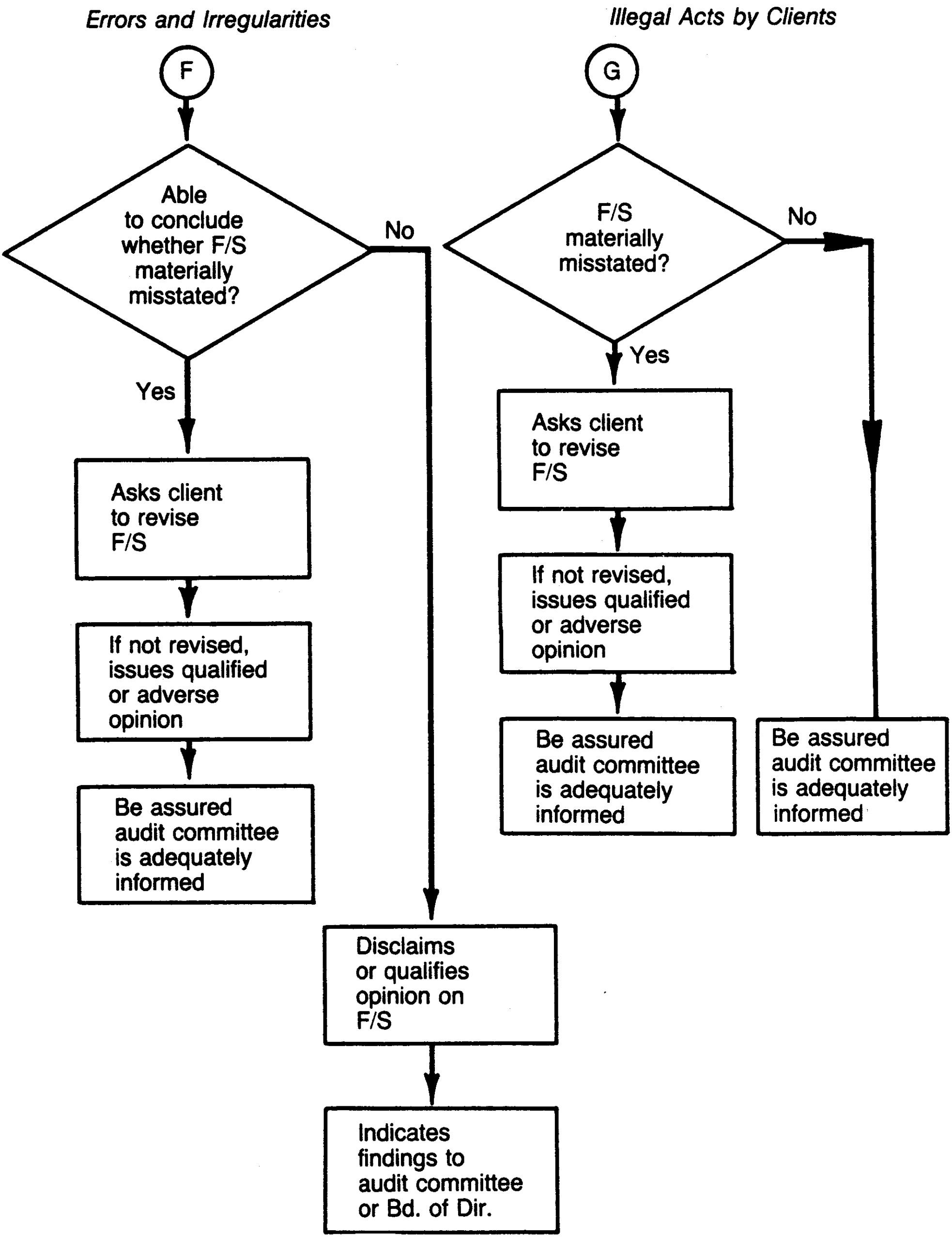


Exhibit 8-13 (cont.)



CHAPTER 9
Internal Control Structure

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Internal Control Structure

This chapter explores the provisions of Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* issued in 1972 by the Auditing Standards Board (ASB). This new SAS supersedes SAS No. 1, *The Auditor's Study and Evaluation of Internal Control, AICPA Professional Standards,* Vol. 1, AU Section 320. (Hereinafter, all references to SASs shall include *Professional Standards* AU paragraph citations.)

This chapter explains the new terminology related to the auditor's responsibility for internal control structure and compares those new terms with the old terms contained in SAS 1 (see Exhibit 9-1). The chapter focuses on the approach and procedures necessary to satisfy the standards set forth in the new Statement, including a description of the minimum knowledge about internal control structure that now is required in every audit as well as the related documentation. In addition, the assessment of control risk and how it affects other necessary audit procedures are discussed.

Exhibit 9-1 *New Standard of Field Work*

A sufficient understanding of the **Internal Control Structure** is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

1. BACKGROUND

SAS 55 on internal control structure was issued to help increase audit effectiveness. More specifically, its objectives are twofold:

- To broaden and clarify the auditor's responsibility to study and evaluate internal control in an audit.
- To incorporate auditing concepts that have been articulated in auditing standards issued subsequent to the issuance of AICPA *Professional Standards*, AU Section 320.

Two significant new concepts were added to the professional standards after the issuance of AU Section 320: control risk, and financial statement assertions and related audit objectives. The incorporation of these concepts into the existing literature resulted in a complete change in the terminology related to the auditor's responsibility. Because the implementation of SAS 55 is expected to be complex, it will not be effective until audits of financial statements for periods beginning on or after January 1, 1990.

2. CHANGES TO EXISTING STANDARDS

While the new Standard is explained in more detail later in this chapter, the following section provides an overview of the changes in the old standards effected by SAS 55. (See Exhibit 9-2.)

The new Statement replaces the concept of *internal control* under AU Section 320 with a concept of *internal control structure* that consists of three components: the control environment, the accounting system, and specific control procedures. Prior authoritative literature defined internal accounting control primarily in terms of *control procedures*. Under SAS 55, internal control is now defined more broadly.

Exhibit 9-2 *Differences Between Old and New Standards*

	Old	*New*
Statement	SAS 1 AU 320	SAS 55
Procedures	Study and evaluation	Obtaining an understanding
Auditor Decision	Determine whether or not to rely on internal control	Assess level of control risk for each assertion from maximum to minimum
Purpose	Restricting procedures	To plan the audit
Minimum Requirement	Understanding of control environment and flow of transactions	Understanding of control environment, accounting system, and control procedures
Procedure Terminology	Review of system	Tests of controls directed toward design
	Compliance tests	Tests of controls directed toward operating effectiveness

The major new performance requirement imposed by SAS 55 is that the auditor now must, in every audit, obtain an understanding of all three control structure elements—the control environment, accounting system, and control procedures—sufficient to plan the audit. This understanding involves obtaining knowledge of the client's policies, procedures, and records relevant to planning the audit. The understanding is used to do three things:

- Identify the types of potential misstatements.
- Consider those factors that may affect the risk of material misstatement.
- Design effective, substantive tests.

The need to obtain such an understanding is the primary difference between the requirements SAS 55 and AU Section 320. The minimum study and evaluation of internal control required under AU Section 320 was more limited: To obtain an understanding of both the control environment and the accounting system. Under SAS 55, in order to design effective substantive tests for some complex situations, it may be necessary to understand control procedures. Without this knowledge of control procedures, the auditor might not recognize potential material misstatements.

Another important difference between SAS 55 and AU Section 320 is that now the auditor must document the understanding of the internal control structure. AU Section 320 permitted the auditor to merely document the decision not to rely on internal control. Now the auditor must document the understanding of the design of the control environment, the accounting system, and control procedures, and indicate whether or not they have been placed in operation.

In addition, SAS 55 outlines the auditor's responsibility both for the internal control structure in terms of control risk as defined in SAS No. 47 *Audit Risk and Materiality in Conducting an Audit*, AU Section 312 (See Exhibit 9-3), and for financial statement assertions as defined in SAS No. 31, *Evidential* Matter, AU Section 326 (See Exhibit 9-4). Recall that financial statement assertions are those broad categories of *matters* that management explicitly or implicitly asserts in presenting financial statements. For example, assertions relevant to balance sheet account balances are existence, completeness, rights or obligations, valuation, and presentation and disclosure. AU Section 320 did not contain the concepts of control risk or financial statement assertions.

While SAS 55 focuses on risk, AU Section 320 focuses on the

Exhibit 9-3 *Audit Risk consists of—*

RISK that the balance or class contains a material misstatement consisting of—	*RISK that the auditor will not detect the misstatement consisting of—*
Inherent Risk The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. For example, cash is more susceptible to theft than an inventory of coal.	Detection Risk The risk that the auditor will not detect a material misstatement that exists in an assertion.
Control Risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.	

complement of risk, or assurance. For example, AU Section 320 discusses the planned level of reliance on internal control which essentially is the opposite of the level of control risk. A low assessed level of control risk would mean a high degree of reliance on internal control. Conversely, if control risk is assessed at the maximum level, then no reliance would be placed on internal control.

The biggest *potential* change in practice arising from SAS 55 is the need to be concerned with control procedures in *every* audit. However, in

Exhibit 9-4 *Control Risk Assessment Process*

Concept	*Example*
Assertion	Completeness of accounts receivable.
Audit Objective	Accounts receivable at the balance sheet date include all amounts owed by customers.
Control Objective	All goods shipped are billed.
Control Procedures	Prenumbered shipping documents; sequence accounted for; goods shipped reconciled with goods billed.

many audits, there may be little, if any, actual change under SAS 55. As the new Statement acknowledges, "Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component of the financial statements or to every assertion relevant to these components." Determining the exact extent of understanding of control procedures needed is considered later in order to effectively plan an audit program.

3. DEFINITIONS

Exhibit 9-5 contrasts the old and new terminology describing the auditor's responsibilities. Although the new terms replace existing concepts, new and old terms are not always identical in meaning.

Certain key terms are defined as follows:

Control risk. The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Internal control structure. The policies and procedures established to provide reasonable assurance that an entity's established objectives will be achieved. For purposes of an audit, it consists of three elements: the control environment, the accounting system, and control procedures.

Exhibit 9-5 *Terminology*

Old	*New*
Internal control	Internal control structure consisting of three elements: • control environment • accounting system • control procedures
Study and evaluation	Control risk assessment process
Review	Tests of controls directed toward design
Compliance tests	Tests of control directed toward operation
Substantive tests	Unchanged
Reliance on accounting control	Assessing the level of control risk below the maximum

Control environment. The overall attitude, awareness, and actions of the board of directors, management, owners, or others with similar authority concerning such matters as organizational structure, the audit committee, and management control methods indicating their philosophy about the importance of control.

Accounting system. The methods and records established to identify, assemble, classify, analyze, record, and report an entity's transactions and to maintain accountability for the related assets.

Control procedures. Those policies and procedures in addition to the control environment and accounting system established by management to provide reasonable assurance that an entity's established objectives will be achieved (for example, proper authorization; segregation of duties; adequate documents and records; adequate safeguards over assets; and independent checks on performance).

4. OVERVIEW OF CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE

This section reviews each major step involved in the auditor's consideration of the internal control structure. The process is then explained, step by step, in subsequent sections in this chapter.

The consideration of the internal control structure in a financial statement audit involves five major steps:

1. Obtain an understanding of (a) the design of relevant internal control structure policies and procedures and (b) whether or not they have been placed in operation. The understanding should include all three elements of the internal control structure.
2. Document the understanding of the internal control structure obtained to plan the audit.
3. Assess the control risk by—
   — Considering the misstatements that could occur in financial statement assertions,
   — Identifying policies and procedures relevant to specific assertions.
   — Performing tests of controls to evaluate the effectiveness of the design and operation of policies and procedures in preventing or detecting material misstatements in assertions.

4. Document the basis for conclusions about the assessed level of control risk for financial statement assertions.
5. Use knowledge obtained from an understanding of internal control structure and from assessed level of control risk in designing substantive tests for these assertions.

In addition to assessing control risk (step 3 above) based on an understanding of the internal control structure (step 1 above), the auditor may desire a further reduction of the assessed level of control risk for some assertions. In that case—

- if it is likely that additional evidential matter could be obtained to support a lower assessed level of control risk, and
- if it is also likely to be efficient to obtain such evidential matter, then
- the auditor should perform additional tests of controls to obtain evidential matter for the assertions and, based on that evidential matter, assess control risk accordingly.

In some cases, the procedures used to obtain an understanding of the control structure and to assess control risk may be performed concurrently.

5. OBTAINING AN UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

In all audits, the auditor should obtain an understanding of each of the three elements comprising the entity's control structure sufficient to plan an audit of the entity's financial statements. (See Exhibit 9-6.) The level of understanding of each element—the control environment, the accounting system, and control procedures—that the auditor should obtain varies based on—

- The complexity and sophistication of the entity's operations and systems.
- The auditor's previous experience with the entity.
- The assessment of inherent risk (that is, the susceptibility to material misstatement).
- The auditor's understanding of the particular industry.
- The auditor's judgment about materiality.

Exhibit 9-6 *Understanding of Internal Control Structure*

Control Environment
- Management philosophy and operating style
- Organizational structure
- Functioning of board of directors and audit committee
- Methods to assign authority and responsibility
- Methods to monitor performance and follow-up
- Personnel policies and procedures
- External influences

Accounting System
- Major classes of transactions
- How transactions are initiated
- Accounting records, supporting documents, and general ledger accounts
- Accounting processing, from transaction initiation to inclusion in the financial statements
- Financial reporting process

Control Procedures
- Proper authorization
- Segregation of duties
- Types of documents
- Access to assets
- Independent checks

5.1 Control Environment

The auditor should obtain an understanding of the *control environment* that is sufficient to assess both the management's and the director's attitude, awareness, and actions concerning the following factors:

- Management philosophy and operating style
- Organizational structure
- Function of the board of directors and its audit committee
- Management control methods (i.e., use of budgets, internal audit function, etc.)
- Personnel policies and procedures
- External influences (i.e., the requirements of legislative and regulatory bodies)

5.2 Accounting System

Ordinarily, the auditor's understanding of the *accounting system* should include the following:

- The major classes of transactions engaged in
- How those transactions are initiated
- The accounting records, supporting documents, and general ledger accounts involved in *data processing*
- The accounting data processing, from the initiation of a transaction to its inclusion in the financial statements, including how the data processing system is organized
- The financial reporting process used to prepare the financial statements, including estimates and disclosures

5.3 Control Procedures

The understanding of *control procedures* necessary for audit planning depends on what the auditor judges to be necessary to accomplish the following:

- Identify the types of potential material misstatements in the financial statements
- Design effective substantive tests

Ordinarily, an understanding of *all* of an entity's control procedures is not necessary for audit planning. The extent of understanding of control procedures that is necessary varies according to the extent of knowledge obtained from other sources about potential causes of misstatements along with the other considerations described above, such as the complexity and sophistication of the entity's operations and systems. For example, in a computerized system with computer-initiated transactions, an understanding of control procedures may be necessary to know which types of errors or irregularities could occur. A simple operation with simple, routine accounting processing may require a limited knowledge of control procedures, or no knowledge at all.

5.4 Procedures to Obtain an Understanding

In every audit, the auditor should obtain a sufficient undestanding of each of the three elements. This understanding is obtained by performing procedures to determine two things: first, the design of policies and procedures relevant to audit planning and second, whether those policies and procedures have been placed in operation.

SAS 55 introduces a distinction between *placed in operation* and *operating effectiveness*. A policy or procedure is *placed in operation* when that policy or procedures actually exists and is in use. In other words, the policy or procedure is not just a written statement or goal, but has already been implemented. *Operating effectiveness* refers to whether a policy or procedure has been used over a period of time, how consistently it has been used, and who has applied it.

Ordinarily, the auditor's understanding of the control structure *design* is obtained through a combination of the following:

- Previous experience with the entity
- Inquiries of appropriate management, supervisory, and staff personnel
- Inspection of entity documents and records
- Observation of entity activities and operations

The auditor's understanding of whether policies, procedures, methods, and records have been *placed in operation* ordinarily is obtained by inspecting documents and reports related to the policy or procedure or by directly observing the policy or procedure in use.

These procedures may be combined in what is sometimes called a *walk-through*. That is, the auditor follows one or more applications of a particular policy, procedure, or transaction, processing while observing the related actions and documents involved. For example, the auditor may select one, or a few, specific transactions and then observe the documents and records used as well as those actions related to processing.

6. ASSESSING CONTROL RISK

Procedures to assess the control risk may be performed concurrently with those to obtain an understanding of the control stucture. Note that the auditor's assessment of control risk will influence the detection risk that the auditor is willing to accept for substantive tests of account balances.

Basically, assessing control risk involves two steps. The first step is to identify the control structure policies and procedures that pertain to a specific audit objective for a specific financial statement assertion (for example, existence, completeness, or valuation). For instance, a specific audit objective for accounts receivable related to the completeness assertion would be that accounts receivable at the balance sheet date include all amounts owed by customers. In this case, one relevant control structure policy or procedure might be to use prenumbered shipping documents sequentially accounted for, or a periodic client reconciliation of goods shipped with goods billed.

The second step is to evaluate the effectiveness of those policies and procedures in achieving or contributing to the achievement of the audit objective. For example, do the client's policies and procedures provide reasonable assurance that all goods shipped are billed, or is there more than a relatively low risk of material misstatement arising from unrecorded sales?

The auditor is not required to evaluate the operating effectiveness of control structure policies and procedures in obtaining an understanding of the internal control structure necessary to plan the audit. However, if the auditor wants to assess control risk at less than the maximum level, then it is necessary to evaluate operating effectiveness.

The auditor makes an initial assessment of the level of control risk for financial statement assertions based on the procedures described in Section 5.4, "Procedures To Obtain an Understanding." If the auditor extends that control risk assessment beyond the understanding of the control structure, then he or she should obtain evidential matter sufficient to support an assessment that the control structure policies and procedures related to a particular assertion are—

- Suitably designed to prevent or detect material misstatements in that assertion.
- Operating in a manner consistent with the auditor's assessment of the level of control risk.

The evidence may be obtained in one of two ways. First, if the understanding provides evidence of the effective operation of a control structure element, then the auditor may be able to assess control risk at less than 100 percent, based on the minimum required understanding of the control structure. For example, to determine that a computerized control has been placed in operation, the auditor may have examined several exception reports generated by the operation of the programmed control procedure. The auditor may conclude that an inspection of these reports, combined with the understanding obtained from reviewing related policies and procedures, is sufficient to support a lower assessed level of control risk.

The second way to obtain the evidence is to apply additional procedures beyond those applied to obtain an understanding. This would be done when the auditor believes it would be efficient to seek a further reduction in the assessed level of control risk for some assertions. In this case, the auditor would apply additional tests of controls.

SAS 55 uses the term *tests of controls* to replace two terms used in AU Section 320: *review* and *compliance tests*. Tests of controls are defined as procedures directed toward either the design or the operating effectiveness of an internal control structure policy or procedure.

Tests of controls directed toward the *design* of an internal control structure policy or procedure are concerned with whether it is suitably designed to prevent or detect material misstatements in specific financial statement assertions. For example, are the policies and procedures related to handling and recording cash receipts suitably designed to ensure that all cash received is recorded? If not, there may be a risk of material misstatement related to the completeness assertion for cash.

Tests of controls directed toward the *operating effectiveness* of an internal control structure policy or procedure are concerned with three things: How the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied.

Both types of tests of controls include such procedures as inquiries of appropriate entity personnel; inspection of documents and reports; and observation of specific internal control structure policies and procedures. In addition to these types of audit procedures, tests of controls directed toward operating effectiveness may also call for the auditor to reperform the application of a policy or procedure.

7. DOCUMENTATION OF THE INTERNAL CONTROL STRUCTURE

The auditor should document both the understanding of an entity's internal control structure elements obtained to plan the audit as well as the assessment of control risk. The form and extent of documentation of the understanding of the internal control structure is influenced by the entity's size and complexity as well as by the nature of its internal control structure. For example, for a small, uncomplex business, the documentation could be in the form of a brief narrative description rather than in flow-charts or questionnaires.

The form and content of documentation of the assessment of the level of control risk depends on the level actually assessed. For assessments at the maximum level, that conclusion alone needs to be documented. For assessments at less than the maximum level, more documentation is necessary. The auditor should document the basis for the conclusion, that is, the evidence of the effectiveness of the design and operation of policies and procedures that support the assessed level. For example, this documentation might include descriptions of tests of controls applied to internal control structure policies and procedures; the results of those tests, and the auditor's evaluation of the operating effectiveness of the policies and procedures tested.

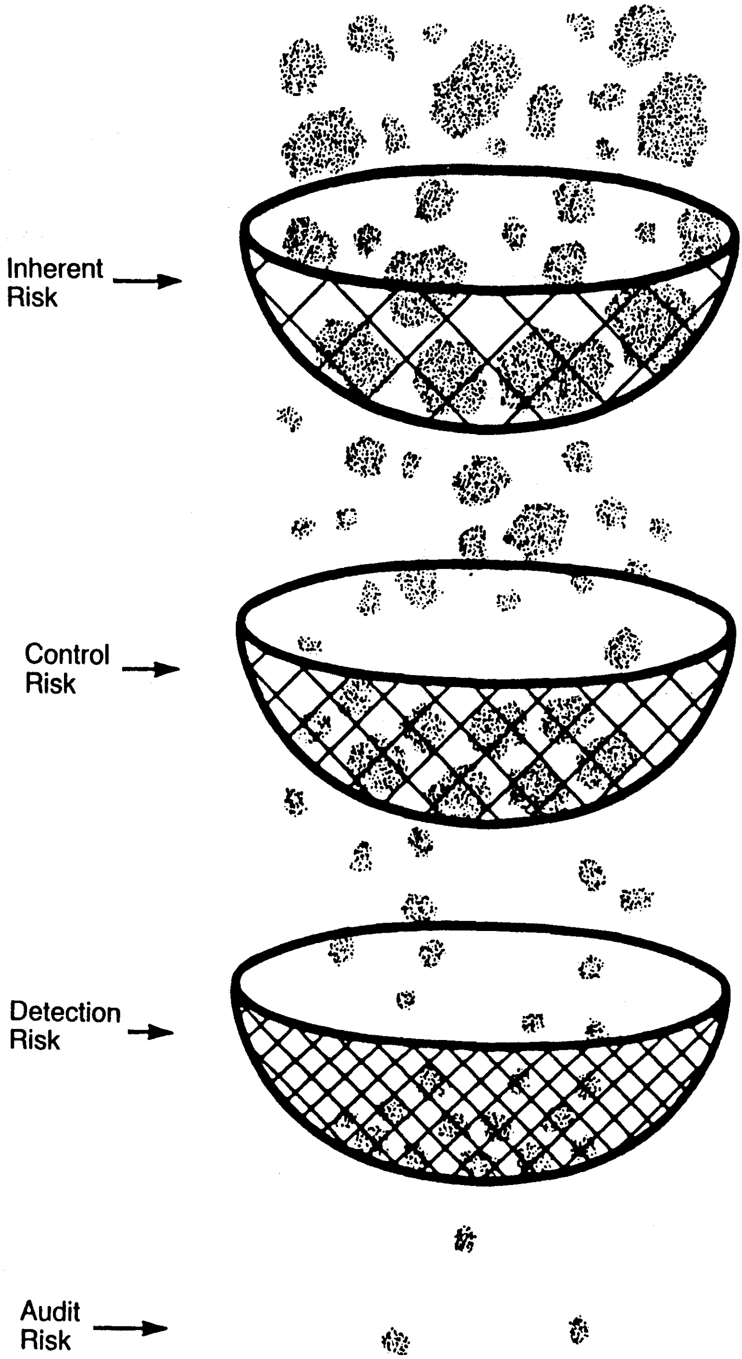
8. CONTROL RISK AND AUDIT PROGRAM PLANNING

The assessment of control risk affects audit program planning in two ways. First, the understanding of the internal control structure provides the auditor with the knowledge of both potential material misstatements and the risk of their occurrence. This knowledge is used to design substantive tests that should be effective in detecting material misstatements.

Second, after obtaining the understanding, the auditor should assess the control risk for the assertions for each of the material components of the financial statements. For some assertions, the auditor may assess control risk at the maximum level, that is, 100 percent, either because policies and procedures are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating their effectiveness would constitute an inefficient audit approach.

The assessed level of control risk is the level of control risk used by the auditor to determine the detection risk for a financial statement assertion. (See Exhibit 9-7.) This level may vary along a range from maximum to minimum, as long as the auditor has obtained evidential matter to support the assessed level. The acceptable detection risk is used by the auditor to determine the nature, timing, and extent of substantive tests. The lower the acceptable detection risk, the more effective the substantive tests must be. The auditor must evaluate the contribution of the control structure policies and procedures to achieving the audit objectives.

Exhibit 9-7 *Components of Audit Risk*



9. IMPLEMENTATION ISSUES

9.1 Effective Date

SAS 55 is effective for audits of financial statements for periods beginning on or after January 1, 1990. For entities with a twelve-month accounting period and a calendar year end, for instance, SAS 55 will apply to the audit of the financial statements for the period ended December 31, 1990. This is one year later than the effective dates of other new SASs. SAS 55 broadens the auditor's responsibility to consider internal control for *all* audits. This expanded responsibility significantly affects audit planning; therefore, the ASB gave practitioners extra time to implement the new requirements.

However, early application of SAS 55 is permissible. Until the Statement becomes effective, the auditor can implement it on some, but not all, audit clients. In addition, for some engagements the auditor can implement the Statement on a piecemeal basis for some cycles of an entity, as long as the auditor reaches full implementation by the effective date. For example, the auditor might obtain and document the necessary level of understanding for the revenue and treasury cycles in the audit for December 31, 1988. For the audit for December 31, 1989, the auditor could do the expenditure and conversion cycles. By December 31, 1990, the auditor would need an appropriate level of understanding and documentation for *all* cycles.

9.2 Walk-Throughs

Some auditors have questioned whether there is a specific number of transactions that should be "walked-through" in order to satisfy requirements to understand the internal control structure. The answer is no. Whether to do any walk-throughs at all depends on the auditor's judgment. The number of walk-throughs or other procedures that the auditor should perform to obtain an understanding of the internal control structure varies, depending on the specific internal control structure policy or procedure involved; the assessment of inherent risk; judgments about materiality; and the complexity and sophistication of the client's internal control structure. Once the auditor decides to use walk-throughs in an area, however, the minimum required is one transaction of each significant type. More than one may be appropriate, depending on the situation.

9.3 Minimum Requirements for Internal Control Structure Consideration

If the auditor does not intend to rely on internal control (e.g., for a small business), the auditor still is required to obtain an understanding of the internal control structure sufficient to plan the engagement. However, SAS 55 does *not* require auditors to evaluate the effectiveness of the design or operation of policies and procedures when obtaining this understanding.

In audits of small owner-managed entities where there is no segregation of duties, auditors may find it more efficient and effective to obtain sufficient evidential matter from substantive testing. For instance, the auditor may assess control risk at the maximum level for all assertions and perform no tests of controls to determine the effectiveness of design and operation of the internal control structure policies and procedures. In this case, the auditor is required to document the understanding of the internal control structure obtained and also to indicate in the audit workpapers that control risk has been assessed at the maximum level for the assertions.

9.4 Minimum Level of Control Risk Assessment

Can the auditor assess control risk low enough for all assertions to preclude the need for substantive testing? The answer is no. As discussed in paragraph 63 of SAS 55, the auditor should perform substantive tests for significant account balances and transaction classes, regardless of the assessed level of control risk.

9.5 Requirement for Tests of Controls

Based on the understanding of the internal control structure, can auditors assess control risk at less than maximum without performing tests of controls? SAS 55 indicates that assessing control risk below the maximum level involves, among other things, testing controls to evaluate the effectiveness of such policies and procedures; thus, tests of controls would be needed in this situation.

However, the auditor may find that the procedures designed to obtain an understanding of the internal control structure also provide evidence about the effectiveness of the design and operation of the policies and procedures. In this case, separate (that is, additional) tests of controls are *not* needed. If the auditor's procedures to obtain an understanding of the internal control structure also yield knowledge of the effectiveness of the policies and procedures relevant to specific assertions, they are in fact tests of controls. For those assertions, the auditor may assess control risk at less than maximum. For example, the auditor may perform a walk-through of cash receipts transactions and concurrently test the operating effectiveness of controls related to the separation of handling and recording cash.

9.6 Accounting Controls and Administrative Controls

AU Section 320 included the definitions of *accounting controls* and *administrative controls*, but these terms are not included in SAS 55. Are the terms now obsolete? Certainly not. They still are useful concepts and are defined in the Single Audit Act of 1984 as well as in other regulatory acts. SAS 55 does not supercede or nullify the requirements of such legislation or regulatory acts.

9.7 Reliance on Work of Internal Auditors

SAS 55 replaces the concept of *reliance* with *assessment of control risk*. However, the factors considered by auditors to make an assessment of control risk at less than the maximum level, relative to internal auditors, are those same factors that are considered in determining reliance on the work of internal auditors. Therefore, SAS 55 has not resulted in significant change with respect to the auditor's reliance on the work of internal auditors.

9.8 Assessment at the Assertion Level

The following is an illustration of how to apply SAS 55 to a particular account, in this case, accounts receivable. Once the auditor has obtained an understanding of the internal control structure sufficient to plan the audit, the auditor must then assess control risk at the assertion level. The auditor should consider the assertions that underlie accounts receivable, such as valuation, completeness, rights and obligations, existence, and presentation. After that, the auditor should consider audit objectives relative to these assertions. Once the audit objectives have been identified, the auditor must then consider the entity's internal control structure to determine what, if any, policies and procedures exist to ensure that each audit objective is met and how effectively these policies or procedures meet that objective.

This illustration continues to use one assertion underlying accounts receivable: valuation. The auditor first must consider the related audit objectives. One objective may be to determine which policies or procedures exist in the entity's internal control structure to ensure that credit sales recorded are collectible.

For example, the entity may have a policy whereby the owner-manager approves credit terms for customer orders over $2,500. The auditor may determine from inquiry and observation that management considers approval of credit terms to be effective in reducing losses from uncollectible sales. Also, in performing other tests of controls, such as inspecting a number of credit sales invoices in excess of $2,500 for management's approval, the auditor should then determine if there is consistency in the application of the approval procedure for the period.

Based on the results of inquiry, observation, and inspection, the auditor has determined there is a policy placed in operation designed to reduce losses from uncollectible sales. Furthermore, the auditor has obtained evidential matter regarding the operation of the procedure, based on the knowledge obtained about the effectiveness of the policy in meeting the stated objective, including the consistency with which it was applied and by whom. Therefore, the auditor has a basis for reducing control risk below the maximum level. The auditor can decide the nature, timing, and extent of substantive audit procedures required relative to this financial statement assertion, based on the assessment of control risk.

9.9 Tests of the Control Environment

The control environment is composed of such factors as management's philosophy and operating style, and personnel policies and practices. What type of procedures would auditors perform to test the effectiveness of the control environment? Factors such as those existing in the control environment that are conducive to testing by inquiry and observation. For example, auditors may inquire about policies and procedures related to the internal audit function, such as its authority and reporting relationships as well as the qualifications of the staff. Further testing may involve observation to support the responses obtained from the inquiry of management.

9.10 Quantification of Level of Control Risk

Control risk can be assessed in quantitative terms, such as percentages, or in non-quantitative terms that range from maximum to moderate to low. For example, if the auditor judges the risk to be great enough that a material misstatement could occur in a financial statement assertion, without being prevented or detected on a timely basis by an entity's internal control structure, then the auditor may indicate in quantitative terms that the control risk is assessed at 100 percent or in non-quantitative terms that the risk is assessed at maximum.

9.11 Inherent Risk

SAS 55 does not require auditors to explicitly assess and document the inherent risk for financial statement assertions; the Statement only requires auditors to assess control risk. SAS 47 requires the auditor to assess audit risk, which is composed of inherent risk, control risk, and detection risk. Together, SASs 47 and 55 allow auditors to make either a combined or a separate assessment of inherent risk and control risk.

9.12 Multiple Policies and Procedures for an Assertion

There may be many policies and procedures that contribute to the achievement of the control objectives related to an assertion for a particular account balance or transaction class. However, depending on the circumstances, not all policies and procedures need to be tested to support the control risk assessment. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditor judgment. However, the necessity of testing each policy and procedure depends on the relationship of the policies and procedures and their interdependence.

For example, assume that five policies or procedures exist that pertain to the assertion, and that the ability to reduce control risk depends on the effectiveness of all five policies or procedures. If any one policy is not effective, misstatements may occur. In this case, the auditor must perform tests of controls on all five policies or procedures to provide a basis for a reduction in the level of control risk.

On the other hand, if the ability to reduce control risk is dependent on the effectiveness of any single policy or procedure (that is, if one policy is not effective, any of the other four will prevent the misstatement), then the auditor may perform tests of controls on only one of the policies or procedures.

10. SUMMARY

For purposes of an audit of financial statements, the internal control structure consists of the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain an understanding of each of the three elements of the internal control structure sufficient to plan an audit of the entity's financial statements. The auditor should perform procedures to obtain evidence sufficient to provide knowledge about the design of the policies, procedures, methods, and records pertaining to each control structure element and also determine if these policies or procedures have been placed in operation.

If the auditor intends to assess control risk at below the maximum level, then the auditor should obtain evidential matter to support the conclusion that the control structure policies and procedures are suitably designed and operating in a manner consistent with the auditor's assessment of control risk.

The auditor's conclusion about control risk, together with inherent risk, should be considered in determining the nature, timing, and extent of substantive tests.

The auditor should document the understanding of the internal control structure as well as the basis for conclusions on the assessed level of control risk.

A flowchart of the process of the auditor's consideration is presented in Exhibit 9-8.

Exhibit 9-8

Flowchart
Consideration of the Internal Control Structure in a Financial Statement Audit

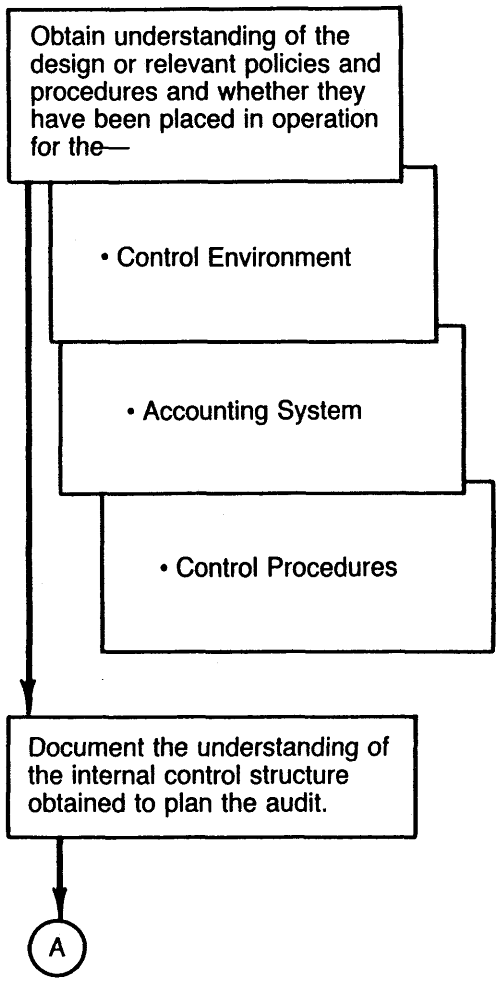


Exhibit 9-8 (cont.)

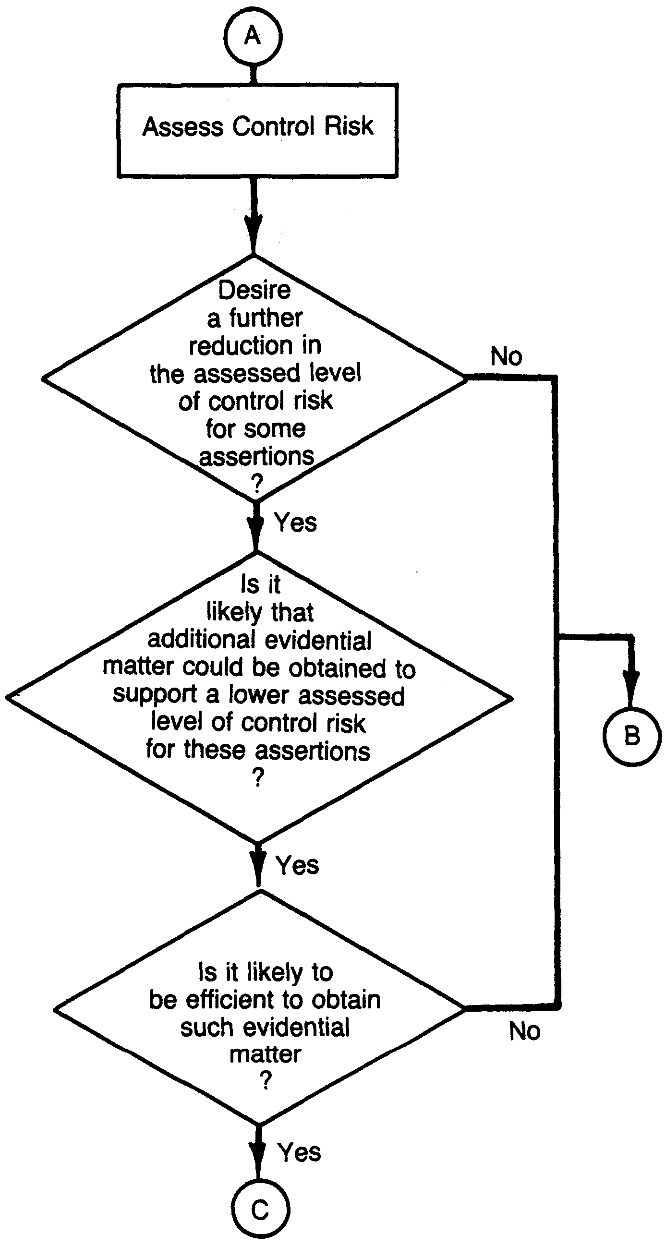
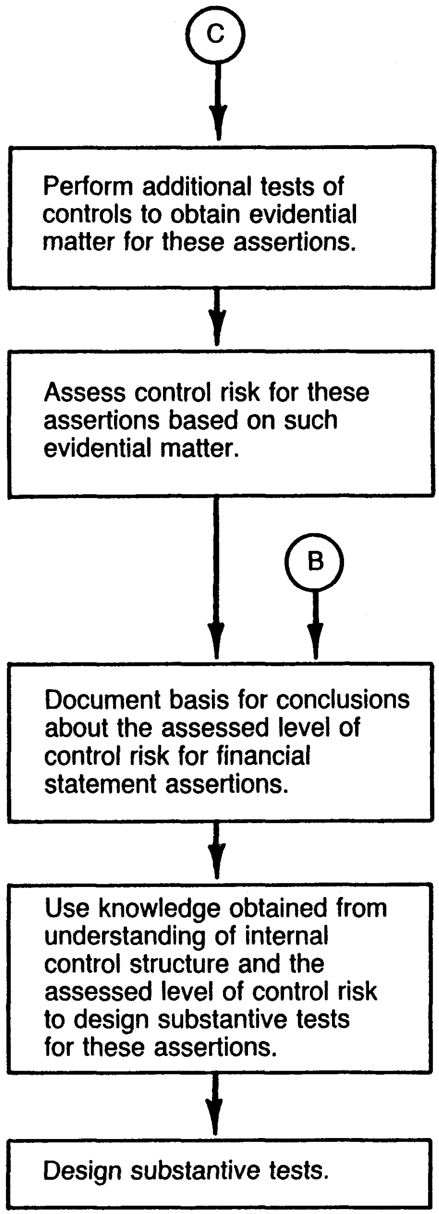


Exhibit 9-8 (cont.)



APPENDIX A

Glossary of Selected Terms and Concepts

Accounting system. The methods and records established to identify, assemble, analyze, classify, and disclose components of financial statements. These include existence or occurrence; completeness; rights and obligations; valuation or allocation; and presentation and disclosure.

Assertions. Management representations that are embodied in the account balance, transaction class, and disclosure component of financial statements. These include existence or occurrence; completeness; rights and obligations; valuation or allocation; and presentation and disclosure.

Assess control risk. The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

Assessed level of control risk. The level of control risk that the auditor uses to determine what detection risk to accept for a financial statement assertion and, accordingly, to determine the nature, timing, and extent of substantive tests. This level may range from maximum to minimum, as long as the auditor has obtained evidential matter to support the assessed level.

Control environment. The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management philosophy and operating style; organizational structure; the function of the board of directors and its committees; methods to communicate the assignment of authority and responsibility; management control methods; the internal audit function; personnel policies and procedures; and external influences concerning the entity.

Control procedures. The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control risk. The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

Effectiveness of design and operation. How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom it was applied.

Internal control structure. The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

Internal control structure policies and procedures relevant to an audit. The policies and procedures embodied in an entity's internal control structure which (a) pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or (b) pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

Maximum level of control risk. The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Placed in operation. An entity is using an internal control structure policy or procedure.

Substantive tests. Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

Test of controls. Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

Understanding of the internal control structure. The knowledge of the control environment, the accounting system, and control procedures that the auditor believes is necessary to plan the audit.

CHAPTER 10
Improving Audit Effectiveness

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Improving Audit Effectiveness

This chapter reviews the following three Statements on Auditing Standards (SASs), issued by the Auditing Standards Board (ASB) early in 1988:

- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- SAS No. 56, *Analytical Procedures*
- SAS No. 57, *Auditing Accounting Estimates*

This chapter discusses the auditor's responsibilities to assess whether substantial doubt exists about an entity's ability to continue as a going concern, and outlines the additional responsibilities when such doubt exists. This chapter also describes the types of analytical procedures that are required in every audit as well as other analytical procedures that are necessary in most audits. It also explains the auditor's objective in evaluating accounting estimates.

A common objective of these three Statements is to enhance the auditor's effectiveness in performing an audit. SASs 56 and 59, which supersede existing statements on the same topics, both impose new responsibilities on the auditor as well as new requirements applicable to every audit of financial statements in accordance with generally accepted auditing standards. SAS 57 provides general advice on the considerations involved in auditing estimates but does not establish any significant new requirements. All three Statements affect the preliminary planning or the final review stages of an audit.

1. AUDIT CONSIDERATION OF GOING CONCERN STATUS

In recent years, critics of the accounting profession have questioned whether the auditor has assumed sufficient responsibility for evaluating the going concern status of a client and for warning of impending business failure. SAS 59 was issued to address this issue.

SAS 59 increases the auditor's responsibility for evaluating the going concern status of an entity. The Statement requires the auditor to consider whether the results of all audit procedures taken together indicate that there is substantial doubt about the entity's ability to continue for a reasonable period of time. SAS 59 defines a *reasonable* period of time as a period not to exceed one year beyond the date of the audited financial statements. In fact, defining this time period is one of the important ways in which SAS 59 differs from prior authoritative literature.

SAS 59 replaced SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence,* which was issued in March 1981. Under SAS 34, the auditor only had to remain aware that audit procedures might uncover information contrary to the going concern assumption. In contrast, SAS 59 obliges the auditor to make an evaluation of whether the results of audit procedures indicate there is substantial doubt about the entity's ability to continue as a going concern. (See Exhibit 10-1.)

The *going concern* concept under SAS 59 is described as follows:

> Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordi-

Exhibit 10-1 *Differences Between SASs 34 and 59*

	Old	*New*
Statement	SAS 34	SAS 59
Auditor Responsibilities	Remain aware that audit procedures might uncover contrary information	Make specific evaluation for substantial doubt for every audit
Existence for Reasonable Period	Guidance not specific	Not to exceed one year
Report	Qualified opinion: "subject to"	Clean opinion with explanatory paragraph
Report Modification Basis	Tied to uncertainty about the recoverability and classification of assets and the amount and classification of liabilities	Determined solely by substantial doubt

narily, information that significantly contradicts the going concern assumption related to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring debt, externally forced revisions of its operations, or similar actions.

1.1 Audit Responsibilities—Going Concern Status

The auditor has two distinguishable sets of responsibilities related to whether an entity has the ability to continue as a going concern. The first is to evaluate whether conditions and events identified during the audit indicate that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, which should not exceed one year beyond the date of the financial statements being audited. This evaluation is done in all audits.

The second set of responsibilities concerns the steps that should be taken by the auditor if conditions or events indicate there could be substantial doubt. In this case, the auditor should—

- Obtain information about management's plans to mitigate the effects of such conditions or events (see Exhibit 10-2).
- Assess the likelihood that such plans can be effectively implemented.
- Conclude whether there is substantial doubt.

If there is substantial doubt, the auditor should consider the adequacy of financial statement disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time. The auditor should also include an explanatory paragraph following the opinion paragraph in the audit report.

If the auditor concludes that substantial doubt does *not* exist, the auditor still should consider whether there is a need for disclosure.

The auditor is not required to plan or perform any audit procedures that are designed solely to search for conditions or events influencing going concern status. However, the auditor is required to evaluate the results of customary audit procedures applied throughout the audit. These procedures include—

- Applying analytical procedures.
- Reviewing compliance with the terms of debt and loan agreements.
- Reading the minutes of meetings of stockholders, the board of directors, and other important committees.

Exhibit 10-2 *Consideration of Management's Plans*

Plans to Dispose of Assets	• Restrictions on disposal of assets, such as covenants limiting such transactions in loans or similar agreements or encumbrances against assets. • Apparent marketability of assets that management plans to sell. • Possible direct or indirect effects of disposal of assets.
Plans to Borrow Money or Restructure Debt	• Availability of debt financing, including existing or committed credit arrangements, such as lines of credit, or arrangements for factoring receivables or sale-leaseback of assets. • Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity. • Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral.
Plans to Reduce or Delay Expenditures	• Apparent feasibility of plans to reduce overhead or administrative expenditures; to postpone maintenance or research and development projects; or to lease rather than purchase assets. • Possible direct or indirect effects of reduced or delayed expenditures.
Plans to Increase Ownership Equity	• Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital. • Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors.

- Reviewing subsequent events.
- Inquiring legal counsel about litigation, claims, and assessments.
- Any other procedures that produce relevant evidence.

When the auditor's evaluation indicates there is substantial doubt about the client's ability to continue as a going concern, SAS 59 requires the auditor to obtain additional information. Actually, once the auditor identifies that there is substantial doubt based on the initial evaluation, the requirements to obtain information under SAS 59 do not significantly differ from those in SAS 34.

Conditions and events that might indicate the existence of substantial doubt include such negative trends as recurring operating losses, working capital deficiencies, and negative cash flows; additional indicators of financial difficulties; and internal or external matters, such as uneconomic long-term commitments or unfavorable legislation. If the auditor believes there is substantial doubt, then the auditor should (a) obtain information about management's plans to mitigate the effect of these conditions or events and (b) assess the likelihood that such plans can be effectively implemented.

1.2 Reporting—Going Concern Status

Even though the requirements for gathering and considering information on going concern status do not significantly differ under SASs 59 and 34, there are other important changes. SAS 59 dramatically changes the modification of the audit report to be made when there is substantial doubt about going concern status. The Statement also changes the cause of the modification.

SAS 59 eliminates the "subject to" qualification for uncertainty about going concern status. Instead, an additional explanatory paragraph on substantial doubt is added as the last paragraph of the report. In addition, determining whether the paragraph is needed is no longer tied to uncertainty about the recoverability and classification of assets, and the amount and classification of liabilities. The need for the explanatory paragraph is determined solely by substantial doubt about an entity's going concern status. Exhibit 10-3 is an example of a standard report with a fourth explanatory paragraph. Note that the opinion is unqualified, yet information on the uncertainty is added.

A disclaimer of opinion due to an uncertainty, including substantial doubt about the entity's ability to continue as a going concern, is never required; however, the auditor may choose to disclaim an opinion.

If substantial doubt becomes apparent in the current period, it does not imply that a basis for such doubt also existed in the prior period. Therefore, an unmodified opinion on prior period financial statements need not be changed.

Exhibit 10-3 *Example Report—Substantial Doubt Regarding Going Concern Status*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

1.3 Documentation of the Going Concern Status Evaluation

SAS 59 does not contain any specific requirements for documenting the evaluation of going concern status. However, because auditing standards require this evaluation, and because it is a significant judgment, the auditor should document the evaluation. The nature and form of this documentation are matters for the auditor's professional judgment. Instead of using a form, the auditor might document the evaluation in a memorandum with a narrative description or evaluation. Another approach would be to include a series of specific yes-or-no questions on going concern status in a checklist. An example of a form is included as Exhibit 10-4.

Exhibit 10-4 *Going Concern Questionnaire*

Client__________ Audit for period ended__________

Prepared by__________ Approved by__________

Date__________ Date__________

Instructions

This form documents our consideration of whether there is substantial doubt about the client's ability to continue as a going concern.

Part I

This part of the form should be completed in all audits. In completing this part, consider the results of all audit procedures applied to date. This consideration should include at least the results of the following procedures: analytical procedures; review of subsequent events; review of compliance with debt and similar agreements; reading minutes; inquiry of legal counsel; and confirmations with related and third parties on arrangements that provide financial support.

Indications	*Conditions or Events Observed in this Audit*
Negative Trends: • Recurring operating losses • Working capital deficiencies • Negative cash flows • Adverse key ratios	
Other Indications of Financial Problems: • Debt default • Dividend arrearages • Denial of credit • Restructuring debt	

Exhibit 10-4 (cont.)

Indications	*Conditions or Events Observed in this Audit*
Internal Matters: • Labor differences • Dependence on success of a particular product • Uneconomic long-term commitments	
External Matters: • Litigation proceedings • Legislation that may jeopardize operations • Loss of a key franchise, license, or patent • Loss of a principal customer of supplier • Uninsured or underinsured catastrophe, such as flood or earthquake	

Part II

This part of the form should be completed only when consideration of the conditions or events in Part I indicates there is substantial doubt about the entity's ability to continue as a going concern. In completing this part, identify elements of management's plans that are particularly significant to overcoming the adverse effects of the conditions or events and obtain evidence about them, including prospective financial information if significant to management's plans.

Identify management plans concerning—	*Describe procedures applied and evidence obtained relevant to plans identified:*
Disposal of Assets:	
Borrowing Money or Restructuring Debt:	
Reducing or Delaying Expenditures:	
Increasing Ownership Equity:	

Exhibit 10-4 (cont.)

After considering management's plans, do you believe there is substantial doubt about the ability of the client to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited)?

Yes ☐ No ☐

If there is substantial doubt, consider the possible effects on the financial statements, the adequacy of related disclosure, and the effect on our audit report.

If you conclude there is not substantial doubt, consider the need for disclosure of the principal conditions and events that initially caused you to believe there was substantial doubt.

2. ANALYTICAL PROCEDURES

As part of general planning, many auditors in the past have applied preliminary analytical procedures to improve their knowledge and understanding of the client. In addition, many auditors have also used analytical procedures as an overall review at the end of the audit. SAS 56 makes these customary practices requirements of auditing standards. The Statement requires the use of analytical procedures both in planning and in the overall review stages of all audits. (See Exhibit 10-5.)

Exhibit 10-5 *Analytical Procedures*

- Required in planning.
- Required in final review.
- Guidance on use as substantive tests.

SAS 56 supersedes SAS 23, *Analytical Review Procedures*. The new standard was issued in response to the Report of the National Commission on Fraudulent Financial Reporting, issued in October 1987, which called for a standard to require independent public accountants to perform analytical procedures in all audits.

Notice the minor change in terminology: SAS 23 calls the procedures *analytical review procedures*, but, under SAS 56, the term has been shortened simply to *analytical procedures*. However, the big change between SASs 23 and 56 is that analytical procedures now are *required* rather then applied at the auditor's option. (See Exhibit 10-6.)

Exhibit 10-6 *Differences Between SASs 23 and 56*

	Old	*New*
Statement	SAS 23	SAS 56
Terminology	Analytical review procedures	Analytical procedures
Requirements	None required	Use of analytical procedures required in audit planning and in overall review phases

2.1 Definitions and Concepts—Analytical Procedures

Analytical procedures are an important part of the audit process. These procedures consist of evaluations of financial information, based on a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to complex models. Plausible relationships among data may be reasonably expected to exist and continue, unless particular conditions cause changes. Changes may be caused by specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements (errors or irregularities).

Understanding financial relationships is essential to effectively plan and evaluate the results of analytical procedures. Generally, this requires knowledge of the client and the industry in which it operates; understanding the purposes of analytical procedures as well as their limitations; and judgment by the auditor.

Analytical procedures may be used for the following purposes:

- To assist in planning the scope of tests of details.
- As a substantive test.
- As an overall review.

In all audits, analytical procedures should be applied to assist in planning the scope of tests of details as well as in an overall review. In most audits, certain audit objectives may be difficult or even impossible to achieve without applying analytical procedures as a substantive test. (See Exhibit 10-7.)

Analytical procedures involve comparisons of recorded amounts to

Exhibit 10-7 *Examples of Analytical Procedures Related to Specific Audit Objectives*

Objective	*Analytical Procedures*
Uncollectible accounts are identified and provided for on a timely basis.	Average accounts receivable TO net sales Average accounts receivable TO bad debt writeoffs Percent of accounts receivable in each aging category
Obsolete, overstocked, and slow-moving inventory are identified and provided for on a timely basis.	Annual sales in units TO ending finished goods inventory quantities Number of days of production in ending finished goods inventory
Commitments and contingencies are identified, monitored, and, if appropriate, recorded or disclosed.	Warranty expense TO cost of sales or units sold Self-insurance reserve TO claims paid

expectations developed by the auditor from a variety of sources, including the following:

- Financial information for comparable prior period(s). This often requires adjustment of prior years' data for known changes.
- Anticipated results, for example, budgets or forecasts, including extrapolations from interim or annual data.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the client operates.
- Relationships between financial information and relevant nonfinancial information.

2.2 Analytical Procedures in Planning an Audit

The use of analytical procedures in the planning phase of the audit is required. However, SAS 56 does not require particular ratios to be calculated or particular comparisons to be made. The choice of which analytical tests are efficient and effective in the particular circumstances are matters for the auditor's professional judgment. The Statement does require the auditor to use analytical procedures during audit planning to enhance the understanding of the client as well as to identify specific risks of material misstatement.

SAS 56 does not draw a sharp distinction between analytical procedures used in general planning and those used in audit program planning. However, note that such a distinction can increase audit efficiency. In this chapter, analytical procedures used in general planning, called *preliminary* analytical procedures, are contrasted with detailed analytical procedures.

Generally, preliminary analytical procedures are used to consider unusual or unexpected balances, or relationships in data aggregated at a relatively high level, such as financial statement line items. For example, the auditor might compare line items for this period to the prior periods, and then compute key ratios, such as accounts receivable and inventory turnover. A gross profit ratio might be compared to the prior annual gross profit ratio.

On the other hand, detailed analytical procedures used in program planning generally use more detailed financial or nonfinancial information. For example, the gross profit ratio by product and by location on a monthly basis might be compared.

Preliminary analytical procedures may include the following:

- *Account balance comparison.* The auditor generally considers account balances in relation to a preliminary expectation, based on previously reported amounts or budgets and forecasts that have been adjusted for known changes in the business, in the industry, or in the economy as a whole.
- *Key ratios.* In addition, the auditor might consider key financial or operating relationships, such as inventory turnover or gross margin percentages, in searching for unusual or unexpected balances, or unexpected relationships.
- *Nonfinancial to financial comparisons.* Consideration of nonfinancial data often may be important in identifying matters that require further investigation (for example, available square footage related to revenue in a retail operation or labor hours related to labor costs).

No specific analytical procedures are expressly required by SAS 56. The sophistication, extent, and timing of the procedures may widely vary, depending on the size and complexity of the client. In some cases, the procedures may consist of comparing changes in account balances from the prior to the current year, using the general ledger or the auditor's preliminary or unadjusted working trial balance. In other cases, the procedures may involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

Preliminary analytical procedures are intended both to improve the auditor's understanding of the client and to identify critical audit areas, that is, balances and transactions for which the risk of misstatement may be high. In contrast, detailed procedures provide evidence about the risk of material misstatement in a particular balance or class of transactions, for example, a comparison of salaries paid with the number of personnel to assess the risk of unauthorized payroll expenditures.

2.3 Analytical Procedures as Substantive Tests

According to SAS 56, analytical procedures may be used as substantive tests to achieve audit objectives. From an efficiency standpoint, it is often desirable to apply analytical procedures as substantive tests *before* beginning audit program planning. The reason: The effectiveness of these analytical procedures often is not known before an evaluation of the results of these tests. In some cases, detailed analytical procedures used in audit program planning may be sufficient to achieve audit objectives related to particular assertions without any detailed testing, or they may permit a reduction in the extent of detailed testing that would otherwise be necessary.

For example, to test the completeness assertion, expected sales might be calculated from production statistics or from square feet of selling space. The result of this analytical test may achieve the audit objective concerning completeness of sales, or it may permit the auditor to reduce the tests of details of shipping records to test that assertion. The degree of reliance that the auditor places on the agreement of recorded amounts with analytically developed expectations will depend on the reliability of the data from which the expectations are developed and on the results of the analytical procedure, as explained above. For example, if the expected sales amount developed by the auditor is not materially different from recorded revenue, then the auditor may conclude that no additional tests of completeness of revenue are necessary. On the other hand, if there is a significant fluctuation, then the auditor will need to include additional tests in the audit program.

2.4 Analytical Procedures in the Overall Review

The primary focus of analytical procedures in the overall review stage is to help the auditor to assess the validity of the conclusions reached, including the opinion on the financial statements taken as a whole. This overall review would generally include consideration of—

- The adequacy of data gathered in response to the unusual or unexpected balances identified in the preliminary analyses.
- Identification of unusual or unexpected balances and of relationships that were not identified in the preliminary analysis or during the audit.

Generally, the overall review would include reading the financial statements and notes as well as considering whether the auditor has obtained an adequate understanding of the client and its financial position and operating results.

2.5 Effectiveness and Efficiency of Analytical Procedures

The expected effectiveness and efficiency of an analytical procedure to detect errors or irregularities depends on, among other things, the nature of the assertion, the plausibility of the relationship, the reliability of the data used to develop the expectation, and the precision of the expectation.

The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:

- Whether the data is obtained from independent sources outside the entity or from sources within the entity.
- Whether sources within the entity are independent of those responsible for the amount being audited.
- Whether the data are developed under a reliable system with adequate controls.
- Whether the data are subjected to audit testing in either the current or a prior year.
- Whether the expectations are developed using data from a variety of sources.

When the auditor investigates and evaluates significant unexpected differences, he or she first should consider and then corroborate plausible reasons for each difference. The amount of difference from the expectation that is acceptable without explanation for a specific account balance or class of transactions should be less than the amount that the auditor believes could be material when aggregated with errors in other balances or classes.

3. AUDITING ACCOUNTING ESTIMATES

SAS 57 provides guidance on obtaining and evaluating evidence to support significant accounting estimates, such as the allowance for uncollectible accounts, warranty expenses, and losses on purchase commitments. The Statement does not impose new requirements or introduce a barrage of new terms. It is primarily a codification of existing good practices.

The ASB issued SAS 57 because accounting estimates can represent significant components of financial statements for some entities. Because these estimates are based on subjective as well as objective factors, management judgment is required to estimate an amount for inclusion in the financial statements. Because of the extent of judgment involved, accounting estimates can lead to material misstatements in the financial statements. Before the issuance of SAS 57, the existing auditing literature did not provide consolidated guidance for the auditor's consideration of accounting estimates; the ASB believes that such guidance was necessary.

An accounting estimate is an approximation of a financial statement element, item, or account. Estimates are necessary in historical financial statements because—

- The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events.
- Relevant data about past events cannot be accumulated on a timely cost-effective basis.

Exhibit 10-8 presents examples of accounting estimates in historical financial statements.

SAS 57 distinguishes the responsibilities of management and the auditor. Under SAS 57, management is responsible for making estimates, while the auditor is responsible for evaluating the reasonableness of these estimates.

Exhibit 10-8 *Examples of Accounting Estimates*

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only; it should not be considered all-inclusive.

Receivables:
Uncollectible receivables
Allowance for loan losses
Uncollectible pledges

Inventories:
Obsolete inventory
Net realizable value of inventories if future selling prices and future costs are involved
Losses on purchased commitments

Financial Instruments:
Valuation of securities
Trading versus investment security classification
Probability of high correlation of a hedge
Sales of securities with puts and calls

Productive Facilities, Natural Resources, and Intangibles:
Useful lives and residual values
Depreciation and amortization methods
Recoverability of costs
Recoverable reserves

Rates:
Annual effective tax rate in interim reporting
Imputed interest rates on receivables and payables
Gross profit rates under program method of accounting

Litigation
Probability of loss
Amount of loss

Accruals:
Property and casualty insurance-loss reserves
Compensation in both stock option and deferred plans
Warranty claims
Taxes on real and personal property
Renegotiation refunds
Actuarial assumptions in pension costs

Revenues:
Airline passenger revenue
Subscription income
Freight and cargo revenue
Dues income
Losses on sales contracts

Contracts:
Revenue to be earned
Costs to be incurred
Percent of completion

Leases:
Initial direct costs
Executory costs
Residual values

Other:
Losses and net realizable value on the disposal of segment or on the restructuring of a business
Fair values in nonmonetary exchanges
Interim period costs in interim reporting
Current values in personal financial statements

The auditor's primary objectives in auditing accounting estimates are to obtain reasonable assurance about the following:

- *Completeness*—All accounting estimates that could be material to the financial statements have been developed.
- *Valuation*—Those accounting estimates are reasonable in the circumstances.
- *Presentation and Disclosure*—Those estimates are presented in conformity with generally accepted auditing principles (GAAP) and are properly disclosed.

SAS 57 encourages the auditor to evaluate estimates with an attitude of professional skepticism and also recognizes that an entity's internal control structure may reduce the likelihood of material misstatement of estimates.

The Statement establishes that the auditor should determine that (a) all material accounting estimates have been developed (b) the estimates are reasonable and (c) the estimates conform with GAAP.

In addition, SAS 57 provides guidance on procedures that the auditor may consider performing to achieve objectives. The Statement recognizes three ways to evaluate the reasonableness of estimates:

1. A future event (an event after the estimate is made but before the completion of audit fieldwork) provides an evidence about actual amount with which to compare the estimate.
2. The auditor understands, evaluates, and reperforms management's process for making estimates.
3. The auditor independently develops an expectation based on knowledge of the facts and circumstances, that is, the auditor develops independent estimates.

Also, the auditor may use some combination of these approaches. (See Exhibit 10-9.)

Exhibit 10-9 *Auditing Accounting Estimates*

- Understand management's process.
- Evaluate.
- Test management's process.
- Independent estimate.
- Subsequent events.

4. IMPLEMENTATION ISSUES

4.1 Effective Dates

SASs 56, 57, and 59 are all effective for audits of financial statements for periods beginning on or after January 1, 1989.

4.2 Documentation of Going Concern Status

While SAS 59 does not have specific documentation requirements, SAS 41, *Working Papers,* requires auditors to document audit procedures performed as well as conclusions reached in audit engagements. Based on this responsibility in conjunction with the responsibilities outlined in SAS 59, auditors should consider documenting the conclusions reached when substantial doubt is alleviated due to management plans and when the auditor concludes that there is substantial doubt.

4.3 Liquidation Plans

If a business, such as a partnership, for example, is to be liquidated at some future date specified in the partnership agreement, does this pose a going concern problem? If the partnership agreement indicates a dissolution date that occurs within one year from the date of the financial statements under audit, then the auditor most likely would have substantial doubt about the entity's ability to continue as a going concern for the reasonable period of time, as defined in SAS 59. In this case, in addition to management's disclosure in the financial statements about the upcoming dissolution, the auditor should include in the audit report an explanatory paragraph, following the opinion paragraph in the audit report, describing the auditor's substantial doubt.

4.4 Going Concern and Development Stage Enterprises

Consider the following situation: A development stage enterprise may not generate substantial revenue, and significant losses may occur. Shareholder equity may even be negative. Once the auditor believes that the conditions and events identified, when considered in the aggregate, indicate that substantial doubt exists, the auditor then should consider management's plans for dealing with the conditions and events. In this case, the auditor would consider management's plans for generating revenue as well as the likelihood that the adverse effect of the negative trends identified will be mitigated. If the auditor concludes that management's plans will not relieve the auditor's substantial doubt for one year from the date of the financial statements, then an explanatory paragraph should be included in the audit report.

Determining whether the shareholder's equity is positive or negative may help the auditor in determining the aggregate effect of the conditions and events identified. However, once the auditor believes there is substantial doubt, ordinarily it is management's plans that will either heighten or mitigate that doubt.

4.5 The Auditor's Explanatory Paragraph vs. Financial Statement Disclosure

SAS 59 does not require the auditor to qualify the audit opinion when substantial doubt about the entity's going concern status exists; it only requires the addition of an explanatory paragraph. Accordingly, some practitioners have questioned whether the explanatory paragraph could be excluded if management adequately discloses the substantial doubt in the notes to the financial statements. SAS 59 requires the auditor to include the explanatory paragraph following the opinion paragraph when the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern. Management's disclosure does not change this requirement.

4.6 Documentation of Analytical Procedures

SAS 56 does not contain specific documentation requirements. Even before SAS 56 was issued, most auditors probably performed analytical procedures, such as reading the financial statements and considering whether the auditor has sufficient understanding, in the overall review phase in all their audits, but the procedures probably were not documented. Now that such analytical procedures are required by professional standards, the auditor should consider the requirements for the amount and type of audit documentation, as outlined in SAS 41.

4.7 Analytical Procedures for a New Entity

Even in the initial year of an entity's operations, the use of analytical procedures during the planning phase of an audit can help the auditor to gain an understanding of the entity's business and to assess the specific audit risks. SAS 56 requires the use of analytical procedures in all audits; however, it does not require comparisons of current-year data to prior-year data. In the initial year of operations, the auditor can benefit from analytical procedures that involve comparisons of monthly or quarterly information and of relationships of financial data to nonfinancial data.

4.8 Extent of Reliance on Analytical Procedures

According to SAS 56, the auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. For audit objectives of some assertions, analytical procedures alone may provide a sufficient level of assurance, and no other substantive procedures would need to be performed. In these cases, the analytical procedures must be precise enough to ensure that the auditor's risk of detecting material misstatements has been reduced to a sufficiently low level.

4.9 Independence and Accounting Estimates

The auditor often assists management in the development of accounting estimates. Since SAS 57 states that management is responsible for developing accounting estimates, does the auditor's assistance in this regard affect the auditor's independence? The answer is no. Under Ethics Rule 101 and Interpretation 101-3, management must accept responsibility for the financial statements, even though they often are prepared by the auditor. The same is true for accounting estimates: Management must accept responsibility for the development of accounting estimates although auditors frequently assist in their development. If the auditor assists management in the development of significant estimates, then good audit practice would include determining that management (a) understands the processes used by the auditor and (b) agrees with significant assumptions used in developing the estimates.

4.10 Documentation of Understanding of Accounting Estimates

SAS 57 does not contain documentation requirements. However, the auditor should consider the provisions contained in SAS 41. Management's understanding and concurrence can be documented in a workpaper, for example, or in the management representation letter. The auditor may also consider SAS No. 61, *Communication with Audit Committees,* which provides guidance on communicating information about management judgments and estimates.

4.11 Compilation and Review Services

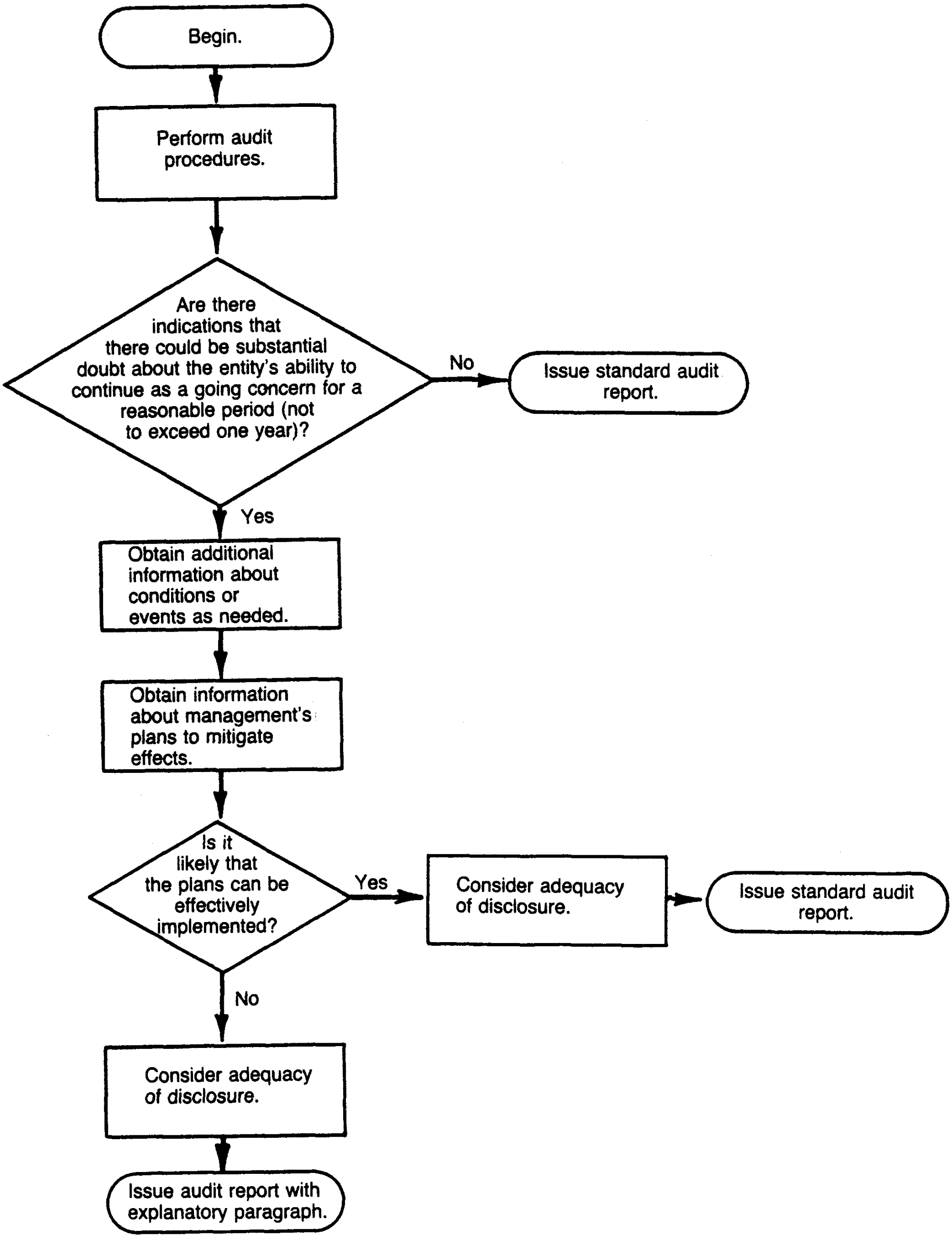
The new Statements do not apply to compilation and review engagements. However, in designing analytical procedures for a review of financial statements, the accountant may find the advice contained in SAS 56 to be helpful. Also, in an engagement to compile or review the financial statements of an entity in financial distress, the accountant might find the guidance in SAS 59 helpful in evaluating the necessity for, and the nature of, the disclosure concerning going concern status.

5. SUMMARY

In every audit, the auditor should assess whether conditions or events identified by customary audit procedures indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period. If there could be substantial doubt about the ability to continue, the auditor should apply additional procedures to gather evidence about management plans to mitigate the negative conditions or events.

If the auditor concludes that substantial doubt exists, then the auditor should (a) add an explanatory paragraph describing the uncertainty to an unqualified audit report and (b) consider the adequacy of disclosure. If the auditor concludes there is no substantial doubt, the auditor still should consider the adequacy of disclosure. A flowchart of the process of the auditor's consideration of going concern status is presented in Exhibit 10-10.

Exhibit 10-10 *Flowchart of the Auditor's Consideration of Going Concern Status*



In all audits, analytical procedures should be applied to assist in planning the scope of tests of details and as an overall review. When the auditor investigates and evaluates significant unexpected differences identified by analytical procedures, he or she first should consider and then corroborate plausible reasons for each difference.

The auditor's objective in evaluating accounting estimates is to obtain sufficient, competent, evidential matter to provide reasonable assurance that accounting estimates are complete and reasonable as well as properly presented and disclosed.

CHAPTER 11
Auditor Communications

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Auditor Communications

This chapter reviews three new Statements on Auditing Standards (SASs), issued early in 1988 by the Auditing Standards Board (ASB), to improve communications with users of the auditor's work. These new SASs are—

- SAS No. 58, *Reports on Audited Financial Statements.*
- SAS No. 61, *Communication with Audit Committees.*
- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.*

The biggest news is the revised auditor's standard report under SAS 58, which is the first significant change in the form of this report in four decades. The new form of report is effective for reports issued or reissued on or after January 1, 1989. However, early application was permitted, and many auditors plan to start using the new form as soon as that was feasible. This chapter reviews the primary features of the new report and the suggested modifications for other than an unqualified opinion.

SAS 61 establishes brand new responsibilities for the auditor's communications with audit committees. However, the applicability of this responsibility has been curtailed from that which would have been imposed by the *exposure draft*. SAS 61 is only applicable to public companies (as defined in the Statement) and to companies that have a formally designated audit or similar committee.

The communication of reportable conditions, in contrast, is a responsibility applicable to *all* audits. SAS 60 supersedes existing guidance on communications of material weaknesses in accounting control.

This chapter reviews the requirements imposed by SASs 60 and 61 on auditor communications within the audited entity. Both of these Statements are effective for audits of financial statements for periods beginning on or after January 1, 1989.

1. REPORTS ON AUDITED FINANCIAL STATEMENTS

SAS 58 is intended to improve the flow and understandability of information that auditors provide to financial statement users. The Statement covers both the standard report and the form of report to be used when conditions or circumstances dictate departures from the standard report.

SAS 58 is a complete revision of AICPA *Professional Standards*, Vol. 1, AU section 509 and includes a revised auditor's standard report. It also completely revises the guidance on reporting on comparative financial statements (AU section 505); guidance on reporting on accounting changes (AU section 546); and related guidance on reporting on loss contingencies, subsequent events, material uncertainties, and departures from Generally Accepted Accounting Principles (GAAP) (covered in auditing interpretations of AU sections 505 and 509). Exhibit 11-1 contrasts the old and new requirements.

Exhibit 11-1 *Key Differences Between SAS 58 and AU Sections 505, 542, 545 and 546*

	Old	*New*
Statement	AU Sections 505, 542, 545, 546	SAS 58
Terminology	"Examined"	"Audited"
Title	None required	Title with word "independent" required
Consistency/ Lack of consistency	Consistency reference made/ qualified opinion	No consistency reference/ clean opinion with explanatory paragraph
Management's Responsibility	No explicit statement	Statement added describing financial statements as management's responsibility
Description of Audit	"Included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances"	Added: objective of detecting material misstatements, and a discussion of the factors involved in achieving reasonable assurance
Materiality	No explicit statement	"Present fairly in all material respects"

1.1 The New Standard Report

One very noticeable difference between the old and new standard report is that the new report has three, rather than two, paragraphs.

First, an *introductory paragraph* identifies the financial statements and states that they were audited. The paragraph distinguishes management's responsibility for the financial statements from the auditor's responsibility to express an opinion on those statements. This explicit statement about the division of responsibility between the auditor and management will be regarded by some as a reduction of responsibility; however, auditors have always maintained this position.

Second, the *scope paragraph* has been changed considerably to better communicate the nature of an audit and the degree of responsibility assumed. This paragraph states that the audit was performed in accordance with generally accepted auditing standards (GAAS) and describes the purpose of an audit. It contains an explicit acknowledgment that an audit provides reasonable assurance that the financial statements are free of material misstatement, and describes those factors involved in achieving reasonable assurance. A brief explanation of what an audit entails is also added. In addition, the paragraph states the auditor's belief that the audit provides a reasonable basis for his or her opinion. Any reasonably short description of an audit is certain to be incomplete. However, the new description is probably less subject to misunderstanding than the prior wording of the scope paragraph. Note that the new report does not treat responsibility for fraud detection differently than the responsibility for other misstatements.

Third, the *opinion paragraph* explicitly recognizes that the auditor's opinion is expressed within the context of materiality. The opinion paragraph states, "In our opinion the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles."

Exhibit 11-2 presents the form of the standard report for a single year presentation. Exhibit 11-3 presents the form for use with comparative financial statements. Note in particular that a title, including the word *independent*, is required. (This requirement does not apply to an accountant's report when the accountant is not independent.)

Exhibit 11-2 *Standard Report—Single Year*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash

Exhibit 11-2 (cont.)

flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Exhibit 11-3 *Standard Report—Comparative Statements*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31,

Exhibit 11-3 (cont.)

19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

The basic elements of the new standard report are as follows:

- A title that includes the word *independent*
- A statement that the financial statements identified in the report were audited
- A statement that the financial statements are the responsibility of management and that the auditor's responsibility is to express an opinion
- A statement that the audit was performed in accordance with GAAS
- A statement that GAAS require the auditor to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
- A statement that an audit includes examining evidence, on a test basis, supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation
- A statement that the auditor believes the audit provides a reasonable basis for his or her opinion
- An opinion as to whether the financial statements are fairly presented in conformity with GAAP
- Signature
- Date

In addition, note that the reference to consistency has been eliminated from the expression of opinion. The exposure draft of SAS 58 had proposed to do away entirely with reporting on the consistency of application of accounting principles. However, consistency reporting has been retained on an exception basis.

1.2 Departures From an Unqualified Opinion

In many cases, modifications of the standard report are made in essentially the same manner as current modifications. However, the new form necessitates some modifications to the standard report for other than an unqualified opinion. SAS 58 also makes other changes simultaneously.

1.2.1 Consistency Modification

When there is a material lack of comparability of the financial statements caused by a change in accounting principle, an explanatory paragraph follows the opinion paragraph, which remains unqualified. The explanatory paragraph simply discloses that there has been an accounting change and contains a cross-reference to the financial statement note that provides the disclosures concerning the change, as required by Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. Exhibit 11-4 illustrates this type of report.

Exhibit 11-4 *Lack of Consistency*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X2.

This change in consistency reporting has resulted in a change in the second reporting standard of GAAS. The wording of the new standard is, "the report should identify those circumstances in which such principles have not been observed in the current period in relation to the preceding period." See Exhibit 11-5.

Exhibit 11-5 *New Standard of Reporting*

The report shall identify those circumstances in which such principles have NOT been consistently observed in the current period in relation to the preceding period.

The same type of explanatory-paragraph treatment used for lack of consistency will also apply to the existence of a material uncertainty, including substantial doubt about the entity's ability to continue as a going concern.

1.2.2 GAAP Departure Qualification

An opinion qualified because of a departure from GAAP has the same first introductory paragraph and second paragraph describing the audit as the standard report. It then has an additional explanatory paragraph describing the GAAP departure as well as the effect on the financial statements. The opinion is qualified, *except for* the effects of the GAAP departure. Exhibits 11-6, 11-7, 11-8, and 11-9 illustrate reports for various types of departures from GAAP.

Exhibit 11-6 GAAP *Departure Qualification—Principle*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Exhibit 11-6 (cont.)

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $____ and $_____, long-term debt by $_____ and $_____, and retained earnings by $_____ and $_____ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $_____ and $_____ and earnings per share would be increased (decreased) by $_____ and $_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Exhibit 11-7 GAAP *Departure Qualification— Inadequate Disclosure*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Exhibit 11-8 *GAAP Departure Qualification—Unjustified Change in Accounting Principle*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidences supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 19X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.

In our opinion, except for the change in accounting principles discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Exhibit 11-9 *GAAP Departure Qualification—Omission of Statement of Cash Flows*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting

Exhibit 11-9 (cont.)

the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 19X2 and 19X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

1.2.3 Scope Limitation Qualification

An opinion qualified because of a scope limitation has the same first introductory paragraph as the standard report. The paragraph describing the audit is modified to state that, except for the matter discussed in the following paragraph, the audit was performed in accordance with GAAS. An additional explanatory paragraph describing the scope limitation is presented next. The opinion is qualified, *except for* the effect of the adjustments, if any, that might have been determined to be necessary had scope not been limited as described above. Exhibit 11-10 illustrates this type of report.

1.2.4 Uncertainty Modification

SAS 58, together with SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, eliminates all "subject to" qualifications. Uncertainties that have a material effect on the financial statements should be disclosed in a required explanatory paragraph following the opinion paragraph. A report with an additional explanatory paragraph because of an uncertainty has the same first introductory paragraph, the same second paragraph describing the audit, and the same opinion paragraph as the standard report. The last paragraph of the report is an explanatory paragraph with a description of the uncertainty indicating that the ultimate outcome is unknown. The paragraph also includes a cross-reference to the financial statement note disclosing the uncertainty. Exhibit 11-11 is an example of a report with an uncertainty modification.

Exhibit 11-10 *Scope Limitation Qualification*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $______ and $______ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Exhibit 11-11 *Uncertainty*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material

Exhibit 11-11 (cont.)

misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

Once SAS 58 becomes effective, a "subject to" qualification will no longer be permitted. This means that, for any report issued after January 1, 1989, the auditor will not be allowed to qualify the opinion subject to an uncertainty.

1.2.5 Adverse Opinion—GAAP Departure

An adverse opinion because of a GAAP departure has the same first introductory paragraph and the same second paragraph describing the audit as the standard report. The third paragraph is an additional explanatory paragraph describing the GAAP departure and the effect on the financial statements. The concluding paragraph states an opinion that the financial statements are not, in all material respects, fairly presented in conformity with GAAP. An example of an adverse opinion is presented in Exhibit 11-12.

1.2.6 Disclaimer of Opinion

A disclaimer of opinion because of a scope limitation begins the first introductory paragraph with the phrase, "we were *engaged* to audit," rather than stating that the auditor actually *audited* the financial statements. The last sentence of that paragraph regarding the auditor's responsibility to express an opinion is omitted, as well as the entire paragraph describing the audit. The concluding paragraph states that the scope was not sufficient to express an opinion and that no opinion is expressed. Exhibit 11-13 illustrates this kind of disclaimer of opinion.

Exhibit 11-12 *Adverse Opinion*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant, and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased $_____ and $_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at $_____ and $_____ in excess of an amount based on the cost to the Company; and deferred income taxes of $_____ and $_____ have not been recorded; resulting in an increase of $_____ and $_____ in retained earnings and in appraisal surplus of $_____ and $_____, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased $_____ and $_____, respectively, because of the effects of the depreciation accounting referred to above; and deferred income taxes of $_____ and $_____ have not been provided, resulting in an increase in net income of $_____ and $_____, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

Exhibit 11-13 *Disclaimer of Opinion—Scope Limitation*

Independent Auditor's Report

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

[*Second paragraph of standard report should be omitted*].

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $______ as of December 31, 19X2, and at $______ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

1.2.7 Transition

SAS 58 indicates that earlier application of its provisions is permissible. However, it would not be logical to apply the provisions of SAS 58 on a piecemeal basis. Instead, all provisions should be applied in tandem. This means that, if an auditor elects to begin using the new standard report earlier than the effective date, then that auditor should follow the guidance that specifies explanatory paragraph treatment for lack of consistency and uncertainties. If an auditor continues to use the old standard report until the new report must be used, then that auditor should continue to issue a qualified opinion for inconsistencies and uncertainties.

SAS 58 provides little guidance on the transition from the old to the new standard report. There seems to be an implicit assumption that a comparative presentation of financial statements will result in the use of the same type of report for both years. For example, if the audit report date is March 12, 1989, on comparative statements as of December 31, 1988 and 1987, the auditor will use the new standard report for both years, even though the old standard report was initially used for the 1987 financial statements. It does not seem to be necessary to mention this change in report format within the report itself.

SAS 58 does deal explicitly with a situation in which there is a material uncertainty that straddles the effective date. For example, assume that the auditor who is now reporting on 1988 and 1987 comparative financial statements issued a "subject to" qualification on the 1987 financial statements upon original issuance. The audit report issued as of March 12, 1989, would be in the new format and would cover both years 1988 and 1987. If the same uncertainty still exists in March 1989, then the auditor would have a fourth explanatory paragraph that describes the uncertainty and indicates its applicability to both 1988 and 1987. If the uncertainty has been resolved, no mention of the uncertainty or the prior "subject to" qualification would be required.

Additional example reports are presented at the end of the chapter.

2. COMMUNICATION WITH AUDIT COMMITTEES

The new communication requirement under SAS 61 is more restricted than the responsibilities imposed by SASs 53, *The Auditor's Responsibility To Detect and Report Errors and Irregularities,* 54, *Illegal Acts by Clients,* and 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* which also expand internal communication responsibilities. SAS 61 applies in the following two general circumstances:

- All SEC engagements, including 1933 and 1934 Securities Act filings; filings under the 1940 Investment Company Act; a filing with a government agency that oversees federally insured financial institutions; and an entity whose financial statements appear in an SEC filing as a sponsor or manager of an investment fund.
- Other entities that either have an audit committee or have formally designated the oversight of financial reporting to an equivalent group, such as a finance or budget committee.

SAS 61 is a new standard and does not supersede or replace any existing literature. As mentioned earlier, this Statement does not in any way change the communication responsibilities discussed in this book concerning irregularities, illegal acts, or reportable conditions in internal control structure.

Exhibit 11-14 outlines the basic requirements for communication with audit committees. The matters to be communicated to the audit committee and the relevant aspects of those matters are as follows:

- Significant accounting policies
- Management judgments and accounting estimates

- Significant audit adjustments
- Other information in documents containing audited financial statements
- The auditor's responsibility under GAAS
- Disagreements with management
- Consultation with other accountants
- Major issues discussed with management prior to retention
- Difficulties encountered in performing the audit.

Exhibit 11-14 *Communication With Audit Committee*

Items To Be Communicated

1. Auditor's GAAS responsibility
2. Significant accounting policies
3. Accounting estimates
4. Audit adjustments
5. Other information
6. Disagreements
7. Second opinions
8. Retention matters
9. Difficulties in performing audit

Exhibit 11-15 highlights the key features of the auditor's responsibility for communication with audit committees. Exhibit 11-16 lists SASs with requirements for communication with audit committees.

Exhibit 11-15 *Auditor Communications*

To Whom:	To the audit committee or a similar, formally designated committee.
What:	Information on the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible.
How:	Oral or written communication. (If oral, document in working papers; if written, report should indicate that it is intended solely for the audit committee, the board of directors, and management.)
When:	After issuance of the audit report on financial statements, unless auditor believes earlier communication is necessary.

Exhibit 11-16 *SASs With Requirements For Communication With Audit Committees*

- SAS No. 61, *Communication With Audit Committees.*
- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.*
- SAS No. 53, *The Auditor's Responsibility To Detect and Report Errors and Irregularities.*
- SAS No. 54, *Illegal Acts by Clients.*
- SAS No. 36, *Review of Interim Financial Information.*

Significant accounting policies include the initial selection of significant accounting policies and their application, methods used to account for unusual transactions, and the effects of ongoing accounting policies in controversial or emerging areas.

Management judgments and accounting estimates include the processes used by management in formulating accounting estimates that are particularly sensitive. Such estimates may be sensitive because of (a) their significance to the financial statements or (b) the possibility that future events may differ markedly from management's current judgments. The basis for the auditor's conclusion about the reasonableness of the estimate should also be communicated.

The *significant audit adjustments* (individually or in the aggregate) arising from the audit include both those adjustments that have been recorded and those that have not. An audit adjustment is defined as a proposed correction of the financial statements detected as a result of applying auditing procedures and which, in the auditor's judgment, may not have been detected otherwise.

The auditor's communication regarding *other information in documents containing audited financial statements* should describe the auditor's responsibility for information outside the financial statements as well as the procedures performed and their results.

The auditor's communication about *responsibilities under* GAAS should describe the nature of the assurance provided by an audit and explain the concepts of materiality, audit tests, and reasonable assurance.

Disagreements with management to be communicated, whether satisfactorily resolved or not, are those about matters that, individually or in the aggregate, could be significant to the entity's financial statements or to the auditor's report. Disagreements do not include differences of opinion based on incomplete facts or on preliminary information that are later resolved.

Communications also include the auditor's views about any matters that were the subject of *consultation between management and an independent accountant* other than the continuing accountant. This is to make sure that the audit committee is appropriately informed about attempts at opinion shopping.

The auditor should communicate the *major issues discussed with management* if the audit committee is not involved in the auditor selection and retention process. The auditor should include any discussion of the application of accounting principles or auditing standards, among other matters.

The difficulties that should be communicated are any serious *difficulties encountered in performing the audit* that (a) were considered detrimental to the effective completion of the audit and (b) may be indicative of conditions that could impair the financial reporting process. Examples of such communications are the unavailability of client personnel; failure of client personnel to complete audit schedules on a timely basis; unreasonable delays by management in permitting the start of the audit or in providing needed information; or a timetable set by management that is detrimental to the audit. The auditor may choose to communicate other matters in addition to those specified.

The communication may be oral or written. If oral, it should be documented by memo or by working-paper notation. If written, the report should indicate that it is intended for the audit committee, the board of directors, and management, as appropriate. See Exhibit 11-17.

The communication need not be made before issuance of the report on audited financial statements, but the auditor may choose to do so for certain matters, such as concerns about the reliability of management representations.

Exhibit 11-17 *Written vs. Oral Report Considerations*

Consider—

- To whom communicated.
- When communicated.
- Complexity of issues.
- Outside use.
- Other considerations.

The auditor's basic responsibility is to make sure that the audit committee is informed about the matters enumerated above. SAS 61 allows management to communicate some of these matters, but the auditor should be certain that such matters have been communicated and reported in proper perspective.

3. COMMUNICATING REPORTABLE CONDITIONS

Issued back in August 1977, SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, required auditors to inform management and the board of directors about any material weaknesses in accounting control procedures. SAS 60 broadens this communication responsibility by requiring the auditor to report significant deficiencies in the internal control environment, the accounting system, or the control procedures. SAS 60 also makes several other significant changes to the existing literature. First, it establishes the concept of reportable conditions. Second, it makes most of the cautionary language in the report optional, superseding SAS 20 and paragraphs 47 to 53 of SAS No. 30, *Reporting on Internal Accounting Control*. Third, it requires communication to the audit committee or its equivalent. See Exhibit 11-18.

SAS 60 provides guidance on identifying and reporting conditions relating to an entity's internal control structure. The Statement requires reporting to the audit committee *reportable conditions*, which are defined as "matters coming to the auditor's attention that, in his or her judgment, represent significant deficiencies in the design or functioning of the internal control structure that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements." A reportable condition is broader in scope than a material weakness since it relates to all elements of the internal control structure—i.e., control environment, accounting system, and control procedures—in contrast to the previously defined system of internal control.

A material weakness seems to be both more significant and more conclusive. It relates to a deficiency in the control structure that *would* permit material errors or irregularities to go undetected. A deficiency could be significant and have an adverse effect, thus being a reportable condition, without rising to the level of a material weakness (for example, a deficiency related to the control environment, depending on the size and

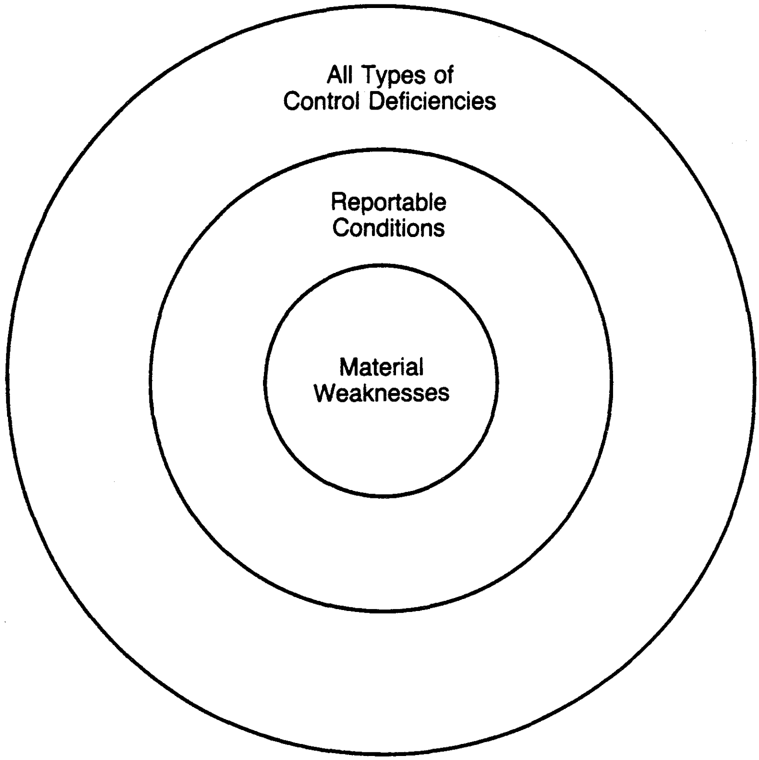
Exhibit 11-18 *Differences Between SAS 60 and SASs 20 and 30*

	Old	*New*
Statement	SAS 20 and para. 47-53 of SAS 30	SAS 60
Matter to Be Reported	Material weakness	Reportable condition
Scope of Matter Reported	Matters related to accounting control	Matters related to the control environment, accounting system, and control procedures
Seriousness of Deficiency	Would permit material errors or irregularities to go undetected	Could adversely affect the organization's ability to record, process, etc.
Cautionary Language Re: Objectives of Control, Inherent Limitations, Projections to Future	Required	Inclusion is optional
Communication	To management and the board of directors	To the audit committee or its equivalent

complexity of the entity). Thus, the concept of a reportable condition has a lower threshold for matters to be reported because the criterion is to "affect adversely" rather than to permit an undetected material error or irregularity. The criterion for a reportable condition also is more subjective and more dependent on auditor judgment than that for a material weakness. In addition, there should be less client resistance because a reportable condition sounds less negative. Exhibit 11-19 depicts the position of reportable conditions and material weaknesses within the universe of control deficiencies. Exhibit 11-20 provides examples of reportable conditions.

Note that SAS 60 does not eliminate the concept of *material weaknesses.* If the auditor is engaged to express an opinion on internal control structure in accordance with SAS 30, the ability to express an unqualified opinion still depends on whether there are material weaknesses. In making the communication required by SAS 60, the auditor may, but is not required to, distinguish between material weaknesses and other reportable conditions.

Exhibit 11-19 *Universe of Control Deficiencies*



SAS 60 also provides guidance on establishing agreed-upon criteria between the auditor and the audit committee for identifying and reporting on additional matters. However, the Statement does *not* require the auditor to search for or to identify reportable conditions beyond those that come to his or her attention in the normal conduct of the audit. In fact, SAS 60 stresses that determining which matters are reportable conditions is a matter of auditor judgment.

If the auditor observes reportable conditions during an audit, the auditor should communicate the matter to the audit committee or other appropriate recipient. The communication generally would be to the audit committee or to individuals with a level of responsibility and authority equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor.

Exhibit 11-20 *Examples of Possible Reportable Conditions*

Deficiencies in Internal Control Structure Design

- Inadequate overall internal control structure design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate procedures for appropriately assessing and applying accounting principles
- Inadequate provisions for the safeguarding of assets
- Absence of other control techniques considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws

Failures in the Operation of the Internal Control Structure

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures
- Evidence of failure to safeguard assets from loss, damage, or misappropriation
- Evidence of intentional override of the internal control structure by those in authority to the detriment of the overall objectives of the system
- Evidence of failure to perform tasks that are part of the internal control structure, such as reconciliations not prepared or not timely prepared
- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Evidence of intentional misapplication of accounting principles
- Evidence of misrepresentation by client personnel to the auditor
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions

Others

- Absence of a sufficient level of control consciousness within the organization
- Failure to follow up and correct previously identified internal control structure deficiencies
- Evidence of significant or extensive undisclosed related party transactions
- Evidence of undue bias or lack of objectivity by those responsible for accounting decisions

Reportable conditions need to be reported no matter what the source of knowledge of the condition. SAS 60 defines the reportable condition in terms of the auditor becoming *aware* of a condition, not in terms of *detecting* the condition. The auditor may learn of a reportable condition while obtaining an understanding of the internal control structure or in applying audit procedures, or someone may tell the auditor.

The auditor also may choose to communicate additional matters related to internal control structure based on previously agreed-upon arrangements with the client. Arrangements to communicate additional matters may be made by higher levels of management as well as by the audit committee. The additional matters related to the internal control structure may be less significant than reportable conditions that the auditor chooses to report. Also, the auditor may choose to communicate observations and suggestions regarding client activities that go beyond internal control structure matters.

If the audit committee has acknowledged its understanding and consideration of both deficiencies and the associated risks, then the matter need not be reported. The decision not to report a reportable condition because of previous acknowledgment is a judgment that the auditor makes with discretion. The auditor can always decide to report the matter; not reporting is only an option.

3.1 Report Form and Content

SAS 60 specifies the form and content of the communication with the audit committee or its equivalent. A written communication is preferred, but oral communication is allowed. If the communication is oral, it should be documented by appropriate memoranda or notations in the working papers.

All reports should include three statements: First, the report should contain a caveat for the intended users of the report, such as, "This report is intended solely for the information and use of management, the audit committee, and others within the organization." Second, every report should include the definition of reportable conditions. Third, the report should indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.

The auditor may choose to communicate during the course of the audit rather than after the audit report date if the auditor believes timely communication is important.

SAS 60 allows the auditor to use additional cautionary language in the report regarding the nature and extent of involvement with the internal control structure, but it does not provide illustrative language or require the use of such language. Such language might include statements about the inherent limitations of the internal control structure and similar matters.

In addition, SAS 60 allows, but does not require, the auditor to differentiate among matters reported. That is, when a report contains both reportable conditions and other matters less significant than reportable conditions, the report may indicate which matters fall in which category. Similarly, if a reportable condition is of such magnitude that it is judged to be a material weakness, then the report may separately identify material weaknesses.

The Statement permits reporting that none of the reportable conditions are considered to be material weaknesses, if appropriate and if the client so requests. However, it prohibits issuance of "no reportable conditions" letters.

Exhibit 11-21 presents an illustration of the form of report that encompasses all the requirements applicable to a report on reportable control conditions.

Generally, public reporting on internal control continues to be governed by SAS 30 (AU §642).

Exhibit 11-21 *Reportable Conditions Report*

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

(Include paragraphs to describe the reportable conditions noted.)

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

4. IMPLEMENTATION ISSUES

The implementation issues for SASs 58, 61, and 60 are organized below into three separate sections.

4.1 SAS 58—Audit Reports

4.1.1 Emphasis of a Matter

The use of an explanatory paragraph has been retained. Paragraph 37 discusses how an auditor may use an explanatory paragraph to emphasize a matter. The Statement is silent about the recommended placement of an emphasis-of-a-matter paragraph in the auditor's standard report; however, footnote 8 of SAS 58 states, "Unless otherwise required by the provisions of this Statement, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report." Therefore, the placement of this paragraph is a matter of auditor judgment.

4.1.2 Explanatory Paragraph Placement (Inconsistency or Uncertainty)

There is a prescribed order of presentation for explanatory paragraphs that describe either a material change in accounting principle or a material uncertainty. Both of these explanatory paragraphs follow the opinion paragraph in the auditor's standard report.

4.1.3 Audit Report Address

SAS 58 states that the auditor's standard report should be addressed to the company whose financial statement are being audited or to its board of directors. The audit report of an unincorporated entity should be addressed as circumstances dictate.

4.1.4 Other Comprehensive Bases of Accounting and Compilation and Review Engagements

SAS 58 does not change the auditor's reports on financial statements prepared in conformity with another comprehensive basis of accounting. However, an exposure draft of a proposed SAS, titled *Special Reports*, contains guidance consistent with SAS 58 about an auditor's report on financial statements prepared in conformity with another comprehensive basis of accounting.

Except for changing the word *examination* to *audit*, the language of an accountant's compilation and review reports will not be affected by the language of the new auditor's standard report.

4.1.5 Explanatory Paragraphs and the SEC

The SEC does not accept opinions qualified for scope limitations or GAAP departures in registration statements. However, the SEC will accept an auditor's report that includes an explanatory paragraph describing a material uncertainty or a change in accounting principles since the auditor's *opinion* is unqualified.

4.1.6 Disclosure of Uncertainties

The addition of an explanatory paragraph to the audit report because of a material uncertainty does not change the auditor's responsibility for evaluating the adequacy of note disclosures related to the uncertainty. The only change brought about by SAS 58 is in the way that the auditor *reports* on material uncertainties.

4.1.7 Reporting When Not Independent

Footnote 3 to SAS 58 indicates that the Statement does not require a title for an auditor's report if the auditor is not independent. Does this imply that the auditor can still audit and report on financial statements when the auditor is not independent? The answer is no. The second general standard requires that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor." When an accountant is not independent, any procedures performed would not be in accordance with GAAS, and, therefore, the auditor would be precluded from expressing an opinion on such statements. Accordingly, the auditor should disclaim an opinion on the statements and specifically state that he or she is not independent. Reporting examples are included in SAS No. 26, *Association with Financial Statements* (AU §504).

4.1.8 Effective Date

According to SAS 58, the statement is effective for "reports issued or reissued on or after January 1, 1989." This means that audit reports released after January 1, 1989, should conform to the requirements of SAS 58.

4.1.9 Reissued Reports

When should the auditor use the new form for the auditor's standard report to reword a previously issued audit report? If the auditor is not aware of any events or circumstances that would cause dual-dating or otherwise change the original report, then there is no need to reissue the report following the new standard report form. This applies even when the previously issued report is incorporated by reference and the auditor includes consent (dated currently) for the use of the report.

However, if the auditor is aware of events or circumstances occurring after the date of the original report that affect that report, then the auditor should modify the report as appropriate and reissue the audit report with a new date, using the language prescribed in SAS 58.

4.1.10 Specialized Industries

The AICPA Auditing Standards Division is currently developing guidance that will update existing audit guides, including report examples, to reflect the new reporting requirements of SAS 58.

4.1.11 Balance Sheet Only Reports

SAS 58 discusses circumstances in which the auditor is engaged to audit and report on the balance sheet only (see Exhibit 11-22). However, the Statement is silent about whether an accountant can accept an engagement to audit the balance sheet but compile or review the related

Exhibit 11-22 *Limited Reporting Engagements— Balance Sheet Only*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

statements of income and cash flows. This is permissible for nonpublic companies. According to statement on standards for accounting and reviews services *SSARS No. 1*, when the accountant performs more than one service on financial statements, the accountant should issue the report that is appropriate for the highest level of service rendered. Exhibit 11-23 presents an example of a report that an accountant might issue with an unqualified opinion on the balance sheet and a standard compilation report on the related statements of income and cash flows.

4.2 SAS 61—Communications With Audit Committees

4.2.1 Topics to Be Covered

SAS 61 lists nine items to be addressed in communications with audit committees. However, an auditor need not address each of the nine items with the audit committee if some of the items are not applicable. For example, if the auditor has had no disagreements with management, then there would be nothing to report.

4.2.2 Internal Auditors

Does the communication by the internal auditor to the audit committee of a significant management judgment or accounting estimate diminish the independent auditor's communication requirements? To some extent, it does, in the sense that the independent auditor does not have to repeat the communication to the audit committee. The auditor's responsibility is to make sure that the audit committee has been informed of the matters covered in the Statement.

4.2.3 Management Letters and SAS 61

Some auditors have questioned whether SAS 61 will preclude the need to prepare management letters to their clients. The answer is no. Auditors generally communicate reportable conditions in management letters. SAS 61 does not alter the communication requirements in other statements but instead adds new ones. An auditor may, however, include some of the matters required to be communicated by SAS 61 in a management letter. For example, the auditor may include a discussion of the level of responsibility that the auditor assumes for the entity's internal control structure in such a letter.

Exhibit 11-23 *Balance Sheet Only Report*

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

We have also compiled the accompanying statements of income and cash flows of X Company for the year ended December 31, 19XX, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying statements of income or cash flows and, accordingly, do not express an opinion or any other form of assurance on them.

4.2.4 Subsidiaries of SEC Registrants

If the auditor audits only a wholly owned or majority-owned subsidiary of an SEC registrant (not the parent), SAS 61 would apply only if the subsidiary has an audit committee or has formally designated oversight of the financial reporting process to a group equivalent to an audit committee, such as a budget or finance committee.

4.2.5 Owner-Managed Businesses

Other auditing standards (for example, SASs 53, 54, and 60) consider an owner-manager to be the equivalent of an audit committee. So then why are small, owner-managed businesses exempted from SAS 61 requirements? Non-SEC entities without the equivalent of an audit committee were exempted because the ASB believed that it did not make sense to require many of the matters to be communicated to an owner-manager.

Communications that would be pointless to make to an owner-manager include disagreements with management, major issues discussed with management before the auditor was hired, and serious difficulties encountered with management during the performance of the audit. However, an auditor is not constrained by the applicability of this Statement and may discuss these and other matters with individuals in an entity who might benefit from these communications. In other words, the applicability of SAS 61 frees the auditor from an obligation to communicate in certain circumstances but does not prohibit communications.

4.2.6 SEC Company Without an Audit Committee

Some small SEC companies may not have an audit committee, but the communication still must be made. It should be made to the board of directors, unless the board has designated another committee, such as a budget or finance committee, to have responsibility for oversight of the financial reporting process. Communication to senior management alone would not be appropriate, unless the board of directors has no members outside of senior management.

4.3 SAS 60—Communication of Reportable Conditions

4.3.1 Material Weaknesses vs. Reportable Conditions

SAS 60 defines a *reportable condition* as a significant deficiency in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A reportable condition may be of such magnitude that it is considered to be a material weakness. SAS 60 defines a *material weakness* as a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In other words, a reportable condition is a deficiency that *could* adversely affect the client's ability to prepare proper financial statements. A material weakness is a more significant reportable condition; it is a deficiency in the control structure that *would* permit material errors or irregularities to go undetected.

Members of management and audit committees generally believe that, during the course of an audit, the auditor becomes aware of information about deficiencies in an entity's internal control structure that would not necessarily have a material effect on the financial statements. In addition, management, audit committee members, or individuals with a level of authority equivalent to an audit committee generally believe that the identification of those types of deficiencies will assist them in fulfilling their financial oversight responsibilities. The ASB agreed that such information obtained during the audit may be useful to those individuals with oversight responsibility. Thus, the Board broadened the auditor's communication responsibility, from reporting material weaknesses to reporting reportable conditions.

Note that the concept of reportable conditions does not replace the concept of material weaknesses. The concept of reportable conditions is applicable only when reporting on internal control structure as part of a financial statement audit. Engagements to report on an entity's internal control structure that are not connected with a financial statement audit are not affected by SAS 60. Accordingly, SAS 60 only supersedes SAS 20 and paragraphs 47 through 53 of SAS 30.

4.3.2 Responsibility for Identification of Reportable Conditions

SAS 60 does not require the auditor to search for reportable conditions. Instead, the auditor is required only to communicate those reportable conditions noted. The auditor's objective in an audit in accordance with GAAS is to form an opinion on the entity's financial statements taken as a whole. In fulfilling this objective, the auditor may become aware of possible reportable conditions in the course of applying normal audit procedures.

4.3.3 Form of Communication

SAS 60 states that reportable conditions preferably should be communicated in writing. However, the standard permits such conditions to be reported orally. If the information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the workpapers.

4.3.4 Reportable Conditions—Reporting Requirements

A written report about reportable conditions should include—

- An indication that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- The definition of reportable conditions.
- A restriction on distribution for the sole use of the audit committee, management, or others within the organization.

4.3.5 Outside Distribution of Reportable Conditions Report

Is the auditor allowed to provide a written report about reportable conditions to individuals outside the entity? Generally, the answer would be no. However, in certain circumstances, it would be permissible. SAS 60 states that the report on reportable conditions is intended solely for limited distribution within the organization (see above). However, the auditor may issue a report about reportable conditions to regulatory agencies, but only when there are requirements established by government authorities to furnish reports about reportable conditions.

4.3.6 "No Material Weaknesses" Report

While SAS 60 precludes the auditor from issuing a written "no reportable conditions" report, the auditor is not prohibited from issuing a written "no material weaknesses" report. The auditor's awareness of reportable conditions varies with each audit and is influenced by numerous factors, including the entity's size, its complexity, and the nature and diversity of its business activities. Because of the potential for misinterpretation of the limited degree of assurance that a written report representing "no reportable conditions" would provide, the ASB has determined that the auditor should *not* issue such a report. The Board believed that a "no reportable conditions" report might confuse users by implying a greater level of assurance than the auditor could really provide about the lack of any significant deficiencies. In contrast, because material weaknesses are identified based on the risk that the condition would result in a material misstatement in the financial statements, material weaknesses have a more direct affect on the auditor's opinion. Thus, there is less potential for misinterpretation from the auditor issuing a written report representing that "no material weaknesses" were noted during the audit. Also, many government regulatory agencies require the auditor to issue reports about material weaknesses in internal control structure.

4.3.7 Less Significant Deficiencies

SAS 60 does not preclude the auditor from reporting matters viewed to be of value to management, even when those items are not significant enough to be classified as reportable conditions.

4.3.8 Completeness of Reporting Reportable Conditions

In some circumstances, the auditor may not be required to report all reportable conditions identified. The existence of a reportable condition may already be known and, in fact, may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk because of cost or other considerations. Management is responsible for making that cost/benefit decision. If the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, then the auditor may decide that the matter does not need to be reported. However, the auditor should periodically consider whether, because of changes in management or in the audit committee, or simply because of the passage of time, it is appropriate and timely to report such matters.

5. SUMMARY

The new form of standard auditor's report consists of three paragraphs. The first paragraph identifies the financial statements and states that they were audited. The *introductory* paragraph also describes the financial statements as management's responsibility.

The second or *scope* paragraph states that the audit was performed in accordance with GAAS. It describes the purpose of an audit as well as the factors involved in achieving reasonable assurance. Further, the scope paragraph states the auditor's belief that the audit provides a reasonable basis for the opinion.

The third or *opinion* paragraph states that the financial statements are fairly presented, in all material respects, in conformity with GAAP. It does not include an expression of an opinion on consistency.

The standard report should be titled, and that title should include the word *independent*.

Changes to the standard report for departures from an unqualified opinion are made in a manner essentially the same as before, except that—

- A disclaimer of opinion for a scope limitation begins with the phrase, "we were *engaged* to audit," the reference to the auditor's responsibility is omitted, and the normal paragraph describing the audit is omitted.
- An uncertainty that materially affects the financial statement does not result in any modification of the opinion paragraph, but the report is modified by adding a description of the uncertainty in an explanatory paragraph.
- An inconsistency in the application of accounting principles that materially affects comparability is described in an explanatory paragraph, with no modification of the opinion paragraph.

SAS 61 specifies that the auditor should make sure that the audit committee is informed about such matters as significant accounting policies; management judgments and accounting estimates; significant audit adjustments; disagreements with management; and difficulties encountered in performing the audit, among other things. The communication to the audit committee can be oral or written and need not be made before the issuance of the report on audited financial statements. The auditor should be concerned about whether the audit committee is informed of significant matters. It may be appropriate for management to communicate certain of these matters. It may not be necessary to repeat the communication of recurring matters.

Finally, SAS 60 states that the auditor should communicate, preferably in writing, observed and reportable conditions to the audit committee or to an equivalent authority. The communication on reportable conditions should include a definition of reportable conditions in internal control structure as well as an indication that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure. Also, there should be a restriction on the intended users.

Examples of departures from unqualified opinions

Exhibit 11-24 *Opinion Based in Part on Report of Another Auditor*

Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_____ and $_____ as of December 31, 19X2 and 19X1, respectively, and total revenues of $_____ and $_____ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Exhibit 11-25 *Predecessor Auditor's Report Not Presented*

Independent Auditor's Report

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

Exhibit 11-25 (cont.)

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Exhibit 11-26 *Updated Report With Different Opinion*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

Exhibit 11-26 (cont.)

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Exhibit 11-27 *Standard Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

Exhibit 11-28 *Standard Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements*

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2 which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $______, long-term debt by $______, and retained earnings by $______ as of December 31, 19X2, and net income and earnings per share would be increased (decreased) by $______ and $______, respectively, for the year then ended.

In our opinion, except for the effects on the 19X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

CHAPTER 12

Pro Forma Financial Information

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Pro Forma Financial Information

The substantial increase in mergers and acquisitions activity has increased the need for guidance on pro forma financial information. In 1984, the Auditing Standards Board (ASB) issued an exposure draft of a Statement of Auditing Standards (SAS) on reporting on pro forma information that the SEC requires public companies to file under Article 11 of Regulation S-X. However, that exposure draft was never issued as a final SAS.

In September 1988, the Board issued a Statement on Standards for Attestation Engagements, entitled *Reporting on Pro Forma Financial Information* (the Statement). As one of the attestation statements, this document explains the application of the general guidance for attestation engagements to engagements to report on pro forma information. Accordingly, the possible levels of service that the accountant can provide related to pro forma information are a *review* or an *examination*. In contrast to the exposure draft, the attestation statement applies to the accountant's involvement with all presentations of pro forma financial information, not just to information required by Article 11.

This chapter covers the guidance on reviews and examinations of pro forma financial information. It discusses the conditions that must be satisfied for an accountant to agree to report on pro forma financial information. It also explains the objective of an examination and of a review of pro forma financial information. In addition, the form of the report appropriate for a review as well as the form appropriate for an examination of pro forma financial information are described.

1. DEFINITION AND USE OF PRO FORMA INFORMATION

Pro forma financial information shows "what the significant effects on historical financial information *might have been* had a *consummated or proposed* transaction (or event) occurred at an earlier date" (emphasis added).

Pro forma information is used to show the effects of a business combination; change in capitalization; disposition of a significant portion of a business; a change in form or status of a business (for example, from a division to a separate entity); or a proposed sale of securities and application of the proceeds. Professional literature that provides guidance related to pro forma information is presented in Exhibit 12-1.

Exhibit 12-1 *The Professional Literature Addressing Pro Forma Financial Information*

- Statement on Standards for Attestation Engagements, *Reporting on Pro Forma Financial Information.*
- Article 11 of Regulation S-X, Securities and Exchange Commission (SEC)—Presentation of pro forma financial information.
- APB Opinion No. 16, *Business Combinations.*
- APB Opinion No. 20, *Accounting Changes.*
- SAS No. 1, AICPA *Professional Standards*, AU section 560, paragraph 5—Pro forma financial information relating to subsequent events.
- SAS No. 58, *Reports on Audited Financial Statements,* AICPA *Professional Standards*—Reporting on audited financial statements that include pro forma financial information for a business combination or subsequent event.
- FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements.*
- FASB Statement No. 5, *Accounting for Contingencies.*
- SAS No. 49, *Letters for Underwriters.*

2. CONDITIONS FOR REPORTING AND THE ACCOUNTANT'S OBJECTIVES

An accountant may agree to *examine* or *review* pro forma financial information if each of the following conditions are met:

- The document including the pro formas also includes complete historical financial statements of the entity for the most recent year. If pro formas are for an interim period, historical interim information for that period is also presented. If the circumstances involve a business combination, the document includes historical data for the significant, constituent part of the combined entity.

- The historical financial statements on which the pro formas are based have been audited or reviewed by an accountant. The level of assurance on the pro formas should be no greater than the level of assurance on the related historical statements.
- The accountant reporting on pro formas should have an appropriate level of knowledge of the entity's accounting and financial reporting practices. Generally, this knowledge will be the result of having audited or reviewed the historical statements. If the accountant was not the auditor or reviewer of the historical statements, then the accountant "should consider whether, under the particular circumstances, he or she can acquire sufficient knowledge."

The objective of an accountant's *examination* of pro formas is to provide reasonable assurance that (a) management's assumptions provide a reasonable basis for presenting the significant effects of the underlying transaction or event (b) pro forma adjustments give appropriate effect to the assumptions and (c) the pro forma column (historicals modified by adjustments) reflects the proper application of the adjustments.

The objective of an accountant's *review* of pro formas is to provide negative assurance on the three aspects of the pro forma information listed in the preceding paragraph. *Negative assurance* indicates that no information came to the accountant's attention that would cause him or her not to believe those three statements.

Note that the objectives of an examination or review do not focus on the final pro forma column alone. The assurance is *not* that the pro forma column conforms with established criteria. Instead, the accountant's objectives relate to the three *separate* aspects of a pro forma presentation:

- Assumptions (reasonable)
- Adjustments (give effect to assumptions)
- Final column (application of adjustments is proper)

3. PROCEDURES

In considering the level of attestation risk that the accountant is willing to accept in a pro forma information engagement, the level of assurance on the underlying historical financial statements is a key factor. Accordingly, the procedures that the accountant should apply to the assumptions and to the pro forma adjustments are substantially the same for either an examination or a review engagement.

The procedures for an examination or review are as follows:

- Obtain an understanding of the underlying transaction or event.
- Obtain a level of knowledge of each significant constituent part of the combined entity in a business combination.
- Discuss with management its assumptions about the effects of the transaction or event.
- Evaluate whether pro forma adjustments are included for all significant effects of the transaction or event.
- Obtain sufficient evidence in support of such adjustments. The evidence needed is a matter of judgment and may vary with the level of service involved.
- Evaluate whether management's assumptions are presented in a sufficiently clear and comprehensive manner and whether they are consistent with each other and with the data used to develop them.
- Determine that computations of pro forma adjustments are mathematically correct and that the pro forma column reflects the proper application of these adjustments.
- Obtain management's representations on (a) its responsibility for the assumptions (b) its belief that the assumptions provide a reasonable basis for presenting all of the significant effects of the transaction or event (c) its belief that the related pro forma adjustments give appropriate effect to the assumptions (d) its belief that the pro forma column reflects the proper application of adjustments and (e) its belief that the significant effects of the transaction or event are appropriately disclosed.
- Read the pro forma financial information and evaluate the appropriateness of the descriptions of (a) the underlying transaction or event (b) the pro forma adjustments and (c) the significant assumptions and significant uncertainties about those assumptions. Also, evaluate whether the source of the historical information base is appropriately identified.

4. FORM OF REPORT ON PRO FORMA FINANCIAL INFORMATION

Exhibit 12-2 illustrates the form of report for an examination of pro forma financial information. Exhibit 12-3 illustrates the report for a review. The

Exhibit 12-2 *Report on Examination of Pro Forma Financial Information*

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

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key elements that the accountant's report on pro forma financial information should include are:

- Identification of the pro forma information.
- Reference to the financial statements from which the historical information is derived and an indication of whether they were audited or reviewed.
- A statement that an examination or review was made in accordance with AICPA standards.
- For a review, a caveat stating that the scope is substantially less than an examination as well as a denial of an opinion.

Exhibit 12-3 *Report on Review of Pro Forma Financial Information—Independent Auditor's Report*

We have reviewed the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. These historical condensed financial statements are derived from the historical unaudited financial statements of X Company, which were reviewed by us, and of Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based on management's assumptions as described in Note 2. Our review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statements amounts in the pro forma condensed balance sheet as of March 31, 19X1, and the pro forma condensed statement of income for the three months then ended.

- A separate paragraph explaining the objective of pro forma information and its limitations.
- For an examination, positive assurance and, for a review, negative assurance that—
  - — The assumptions provide a reasonable basis for presenting significant effects of the transaction or event.

— The pro forma adjustments give appropriate effect to the assumptions.
— The pro forma column reflects proper application of the adjustments to the historical financial statements.

An accountant's report may combine a review of some pro forma information and and examination of other pro forma information (for example, an examination of annual pro formas with a review of quarterly pro forma information). An example of such a report is presented in Exhibit 12-4.

An accountant is required to modify the report for (a) restrictions on the scope of the engagement (b) significant uncertainties about the assumptions that could materially affect the transaction or event and (c) reservations about the propriety of the assumptions or the conformity of the presentation with those assumptions, including inadequate disclosure of significant matters. Examples of modified reports appear at the end of the chapter. (See Exhibits 12-5 through 12-9.)

Exhibit 12-4 *Report on Examination of Pro Forma Financial Information at Year End With a Review of Pro Forma Financial Information for a Subsequent Interim Date*

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

In addition, we have reviewed the related pro forma adjustments and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were reviewed by us, and Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our review was made in accord-

Exhibit 12-4 (cont.)

ance with standards established by the American Institute of Certified Public Accountants.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagements.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion on the pro forma adjustments or the application of such adjustments to the pro forma condensed balance sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. Based on our review, however, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for representing the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended.

5. IMPLEMENTATION ISSUES

5.1 Compiled Historical Financial Statements

If a company with audited financial statements acquires a small, closely held business for which an accountant has compiled the financial statements, is it permissible for that accountant to accept an engagement to report on pro forma financial information? No, not if the operating results of the closely held business are material to the combined entity. The historical base should be audited or reviewed; compilation is not enough. However, the accountant can accept if he or she makes a retroactive review.

5.2 Reporting on Pro Formas for Non-Audit and Non-Review Clients

The issue here is whether an accountant who has not audited or reviewed the historical base can have a significant level of knowledge of the entity's accounting and financial reporting practices, which would have to be obtained to permit the accountant to report on the pro formas. Obtaining this knowledge may be possible in some cases. For example, if the 19X8 pro formas were based on historical financial statements audited by someone else, but the accountant has audited the historical financial statements for 19X9 and, as part of that audit, has reviewed the workpapers of the preceding auditors, then the accountant should have obtained an appropriate level of knowledge.

5.3 Most Recent Year Historical Financial Statements

The Statement requires that the historical financial statements for the most recent year be included in the document containing the pro forma financial information. If the historical financial statements for the most recent year are not yet available, can the accountant accept the engagement to report on the pro formas? The answer is yes. The Statement indicates that the historical financial statements for the preceding year should be included if the financial statements for the most recent year are not available.

5.4 Qualified Report on Historical Financial Statements

The accountant's report on pro forma financial information refers to the financial statements from which the historical financial information was derived and states whether these financial statements were audited or reviewed. If the report on the historical financial statements is a qualified opinion or is otherwise modified, then a reference to that modification should be included in the report on pro forma information.

6. SUMMARY

Pro forma financial information presents what the significant effects on historical information might have been if a particular transaction or event (consummated or proposed) had occurred at an earlier date.

An accountant may accept an engagement to report on pro forma financial information if three conditions are met. First, the document containing the pro formas should include the historical financial statements of the entity for the most recent year. Second, the historical financial statements on which the pro formas are based should have been audited or reviewed by an accountant, and the level of service on the pro formas should be consistent with that on the historical base. Third, the accountant must have an appropriate level of knowledge of the entity's accounting and financial reporting processes.

The objective of an examination is to give positive (reasonable) assurance, while the objective of a review is to give negative assurance on three aspects of the pro forma presentation: First, the assumptions provide a reasonable basis for the presentation. Second, the pro forma adjustments give appropriate effect to the assumptions. Third, the pro forma column reflects proper application of the adjustments.

The procedures for an examination or a review engagement are substantially the same, and the level of assurance is primarily dependent on the level of service on the underlying historical financial information.

The reports on pro forma financial information conform to the basic requirements established by the attestation standards for an examination or a review.

Exhibit 12-5 *Report on Examination of Pro Forma Financial Information—Giving Effect to a Business Combination To Be Accounted for as a Pooling of Interests*

We have examined the pro forma adjustments reflecting the proposed business combination to be accounted for as a pooling of interests described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statements of income for each of the three years in the period then ended. These historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,

Exhibit 12-5 (cont.)

appearing elsewhere herein [*or incorporated by reference*]. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the proposed transaction occurred at an earlier date.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

In our opinion, the accompanying condensed pro forma financial statements of X Company as of December 31, 19X1, and for each of the three years in the period then ended give appropriate effect to the pro forma adjustments necessary to reflect the proposed business combination on a pooling of interests basis as described in Note 1, and the pro forma column reflects the proper application of those adjustments to the historical financial statements.

Exhibit 12-6 *Report on Examination of Pro Forma Financial Information—Scope Limitation Qualification*

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances, except as explained in the following paragraph.

We were unable to perform the examination procedures we considered necessary with respect to assumptions relating to the proposed loan described as Adjustment E in Note 2.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

In our opinion, except for the effects of such changes, if any, as might have been

Exhibit 12-6 (cont.)

determined to be necessary had we been able to satisfy ourselves as to the assumptions relating to the proposed loan, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

Exhibit 12-7 *Report on Examination of Pro Forma Financial Information—Uncertainty Modification*

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

It has been assumed that the transaction described in Note 1 is nontaxable. Such determination is dependent on an Internal Revenue Serivce (IRS) ruling that has been requested but not yet received by management. The ultimate decision by the IRS cannot be determined at this time.

Exhibit 12-8 *Report on Examination of Pro Forma Financial Information—Qualification—Propriety of Assumptions*

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect management's assumption that X Division of the acquired company will be sold. The net assets of this division are reflected at their historical carrying amount; generally accepted accounting principles require these net assets to be recorded at estimated net realizable value.

In our opinion, except for inappropriate valuation of the net assets of X Division, management's assumptions described in Note 2 provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

Exhibit 12-9 *Disclaimer of Opinion on Pro Forma Financial Information—Scope Limitation*

We were engaged to examine the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical con-

Exhibit 12-9 (cont.)

densed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based upon management's assumptions described in Note 2.

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect management's assumptions that the elimination of duplicate facilities would have resulted in a 30-percent reduction in operating costs. Management could not supply us with sufficient evidence to support this assertion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

Since we were unable to evaluate management's assumptions regarding the reduction in operating costs and other assumptions related thereto, the scope of our work was not sufficient to express and, therefore, we do not express an opinion on the pro forma adjustments, management's underlying assumptions regarding those adjustments, and the application of those adjustments to the historical financial statement amounts in the pro forma condensed financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

CHAPTER 13
Compliance Auditing

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Compliance Auditing

A great deal of attention has been focused in the last few years on the performance by independent CPAs in audits of entities that receive financial assistance under government-funded programs. Congressional committees were particularly dissatisfied with audit quality lapses related to federal funding. In 1986, two reports were issued that expressed dissatisfaction with the quality of such audits. The titles alone are a serious indictment of auditor performance:

- Report of the U.S. General Accounting Office (GAO) entitled, "CPA Audit Quality—Many Governmental Audits Do Not Comply With Professional Standards" (March 1986)
- Report of the House Committee on Government Operations entitled, "Substandard CPA Audits of Federal Financial Assistance Funds: The Public Accounting Profession Is Failing the Taxpayers" (October 7, 1986)

These reports added impetus to the calls for increased regulation of the public accounting profession. Early in 1988, the Auditing Standards Board (ASB) issued an exposure draft on compliance auditing. The official title was *The Auditor's Responsibility for Testing Compliance With Laws, Regulations, and Contractual Terms Governing Financial Assistance Certain Entities Receive From Government.* The AICPA appointed a task force to study ways to improve auditor performance in this area. One of the recommendations of that task force was a Statement of Auditing Standards (SAS).

The intent of this Statement is to make auditors more sensitive to government audit requirements and to make government requirements enforceable under the AICPA Code of Professional Conduct.

This chapter reviews the applicability of the Statement, and discusses how to determine whether the Statement would apply to the audit of a governmental or nongovernmental client. The chapter identifies the tests of compliance with laws and regulations that are required by relevant professional standards and government regulations and explains how to plan and perform those tests. In addition, the types of reports issued on compliance with laws and regulations are outlined.

The Statement is expected to be released as Statement on Auditing Standards No. 63 in March 1989. However, when this book went to press, the ASB had not yet voted on the final Statement. This chapter has been prepared based on the best information available to date, but practitioners should be alert for any changes that might occur in the final Statement.

1. BACKGROUND AND APPLICABILITY OF SAS ON COMPLIANCE AUDITING

The AICPA audit guide, *Audits of State and Local Governmental Units*, Section 4.1, defines tests of compliance with laws and regulations as follows:

> The objectives of tests of compliance with laws and regulations are to determine whether there have been events of noncompliance that may have a material effect on the financial statements or to provide a basis of reporting on the government's compliance with such laws and regulations. Accordingly, *tests of compliance with laws and regulations are substantive tests* usually accomplished by examining supporting documentation (emphasis added).

Thus, tests of compliance with laws and regulations should be distinguished from tests of compliance with internal accounting control. Since SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, eliminates the term *compliance test* of controls from the literature, the potential confusion should be reduced.

The Statement would apply to audits of financial statements of (a) governmental units and (b) nongovernmental entities that receive financial assistance from a governmental agency. This means that the Statement applies to audits of state and local governmental units and may apply to some nongovernmental units, such as not-for-profit organizations. The Statement would also apply when the auditor is engaged specifically to test and report on compliance with laws and regulations, whether or not in connection with an audit.

2. TYPES OF AUDITS THAT MAY REQUIRE TEST OF COMPLIANCE WITH LAWS AND REGULATIONS

The nature and extent of the auditor's responsibility for testing compliance with laws and regulations will differ depending on the type of audit. There are three types:

- *Financial audit.* An audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).
- *Audit under government auditing standards.* A GAAS audit plus additional requirements of the GAO's *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* (1988). This type of audit is also called an audit in accordance with generally accepted governmental auditing standards (GAGAS).
- *Single audit.* A GAAS and GAGAS audit plus additional requirements of the Single Audit Act of 1984, as described in the Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments.*

As mentioned earlier, the Statement would apply when a state or local government unit or a nongovernmental entity such as a not-for-profit corporation receives financial assistance from any level of government: federal, state, or local. If the financial assistance is received from a federal agency (either directly or passed through another level of government), the auditor may need to consult the following publications in addition to OMB A-128 to identify the requirements applicable to the assistance:

- *The Compliance Supplement for Single Audits of State and Local Governments* (revised April 1985), published by the OMB as a supplement to OMB A-128.
- OMB A-87, *Cost Principles for State and Local Governments.*
- OMB A-122, *Cost Principles for Nonprofit Organizations.*

The nature and content of each publication are discussed below.

2.1 Compliance Supplement

The OMB *Compliance Supplement* specifies (a) general requirements and (b) specific program compliance requirements as well as suggested audit procedures for 62 federal financial assistance programs.

Those "general requirements" are specified in the *Compliance Supplement* as "requirements that involve significant national policy and of which failure to comply could have a material impact on an organization's financial statements." Accordingly, tests for compliance with those requirements "should be included as a part of every audit of state, local, and tribal governments that involve Federal financial assistance." Those requirements pertain to the following matters:

- *Political activity.* Prohibits the use of federal funds for partisan political activity.
- *Davis-Bacon Act.* Requires that laborers working under federally financed construction contracts be paid a wage established by the secretary of labor.
- *Civil rights.* Prohibits violation of anyone's civil rights in a program funded by the federal government.
- *Cash management.* Requires recipients of federal assistance to minimize the time lapsed between the receipt and the disbursement of that assistance.
- *Relocation assistance and real property acquisition.* Prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate persons displaced when that property is acquired.
- *Federal financial reports.* Prescribes federal financial reports that must be filed.

The "specific requirements" are defined in the *Compliance Supplement* as those requirements that are specific to 62 federal programs which provide approximately 90 percent of all federal aid to state and local governments. Those requirements generally pertain to the following categories:

- Types of services allowed or unallowed
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Special tests and provisions

2.2 OMB Circular A-87

This circular requires that federal assistance programs provided to *state and local governments* and to Indian tribal governments bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

2.3 OMB Circular A-122

This circular requires that federal assistance programs provided to *not-for-profit organizations* bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

3. REQUIREMENTS APPLICABLE TO AUDITS OF ALL GOVERNMENTAL UNITS

The auditor's responsibility related to misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is to (a) assess the risk of such misstatement and (b) based on that assessment, design the audit to provide reasonable assurance that such misstatements are detected. The Statement discusses the characteristics of direct-effect laws and regulations, and lists the Government Accounting Standards Board's (GASB's) illustrations of types of laws and regulations that have a direct and material effect on the determination of financial statement amounts. These illustrations include the following—

- *Reporting entity.* Section 2100 of the GASB *Codification of Governmental Accounting and Financial Reporting Standards* provides criteria for determining the organizations, functions, and activities of government that should be included in the financial statements of the governmental unit. Examples of the criteria include the scope of public services, accountability for fiscal matters, and special financing relationships.
- *Establishment of funds.* Section 1300 of the GASB *Codification* establishes the principles of fund accounting. For example, a state constitution may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.
- *Budgetary reporting.* Section 2400 of the GASB *Codification* requires that the general purpose financial statements present an aggregation of the appropriated budgets, as amended, compared to actual results of operations.

- *Grant revenue recognition.* A grant is a contribution of cash or other assets to be used for a specified purpose. Matching requirements may exist; if so, revenue recognition depends on compliance with those requirements.
- *Restrictions on expenditures.* Proceeds of certain governmental revenues are restricted by law as to the purposes for which they may be spent. For example, a housing program may require distribution of the proceeds only to families meeting eligibility requirements.

The GASB *Codification* further requires disclosure of violations of certain laws and regulations, such as failure to establish funds or expenditures in excess of appropriated budget. It also requires disclosures of the types of investments that governmental units are legally authorized to make and of any violations of provisions for deposits and investments. The auditor should evaluate the adequacy of such disclosures.

4. REQUIREMENTS APPLICABLE TO ALL AUDITS OF ENTITIES THAT RECEIVE FINANCIAL ASSISTANCE FROM GOVERNMENTS

In planning and conducting the audit, the auditor should obtain an understanding of the effects of laws and regulations on the financial statements; assess the risk of material misstatements caused by noncompliance; and perform audit procedures in consideration of that risk.

The auditor is responsible for testing compliance with laws and regulations that have a direct and material effect on the financial statements (except disclosure of contingencies). For example, the GASB *Codification*, Section G60.109, states in its discussion of recognizing revenues from grants, entitlements, and shares revenues that "If cost sharing or matching requirements exist, revenue recognition depends on compliance with these requirements." The auditor should design audit procedures to provide reasonable assurance of detecting noncompliance with such laws and regulations.

In obtaining an understanding of the effects of laws and regulations on the financial statements, the auditor should consider the characteristics of the laws and regulations in *general* as well as *specific* laws and regulations applicable to the entity whose financial statements are being audited.

In obtaining an understanding of specific laws and regulations, the auditor would perform the following steps. First, the auditor should request management to identify the amount of financial assistance received, the government source of that assistance, and the requirements governing that financial assistance that, if not complied with, could have a material effect on the financial statements.

Second, the auditor should assess the materiality of the financial assistance in relation to the financial statements taken as a whole, and assess the risk that noncompliance with requirements governing financial assistance could occur and have a material effect on the financial statements. Note that one factor in this risk assessment is the auditor's understanding of the internal control structure.

Third, the auditor should corroborate management's identification of requirements and obtain an understanding of those requirements. If applicable, the auditor should refer to the *Compliance Supplement*. However, some federal and all state and local programs are not covered by the *Compliance Supplement*. In this case, the auditor should obtain an understanding of the requirements by discussing the compliance requirements with the entity's chief financial official and legal counsel, and review any directly related agreements, such as grant or loan documents. For federal programs, the auditor should inquire of the inspector general of the federal agency providing assistance. For state and local programs, the auditor should (a) inquire of the audit function of the agency that provided assistance (b) inquire of the state auditor or other state audit oversight organization or (c) review information about compliance requirements made available by state CPA societies.

Fourth, the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of those requirements determined to have a direct and material effect. The auditor should consider whether evidence obtained from procedures performed in evaluating the completeness and classification of revenues (for example, sampling from all cash receipts selected to test recording accuracy) indicates possible inadequacies in the identification of sources and amounts of financial assistance. If assistance from various levels of government may have been commingled, then the auditor should consider reviewing contracts or other documentation of assistance, or inquire of the funding source identified by management whether the assistance provided includes assistance from another source. The auditor should consider any applicable, specific requirements related to the receipt of assistance, for example, contract terms governing advances and draws.

Fifth, the auditor should request management to make written representations on its responsibility for compliance governing the assistance received; its disclosure to the auditor of the sources and amounts of assistance; and the adequacy of identification of those requirements governing assistance.

5. ADDITIONAL REQUIREMENTS APPLICABLE TO AN AUDIT IN ACCORDANCE WITH GAGAS

GAGAS are also called the GAO Standards or, more commonly, the "Yellow Book," which was revised in mid-1988. When performing an audit in accordance with GAGAS, certain additional requirements apply. The auditor should issue two reports in addition to an opinion on the financial statements.

The first report is on internal control structure, based solely on the understanding and control risk assessment made as part of the audit of financial statements. There are several differences in the requirements under the Statement and those under SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.* For audits in accordance with GAGAS, a *written* report is required in all audits. Identification of reportable conditions that are material weakness is required as well as coverage of some additional matters, such as identifying controls and the scope of work. Exhibit 13-1 illustrates such a report.

Exhibit 13-1 *Example Report on the Internal Control Structure—GAGAS Audit*

In planning and performing our audit of the financial statements of [name of entity] for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [identify control categories].

Our consideration included all of the control categories listed above except that we did not perform tests of controls to evaluate the effectiveness of the design and operation of policies and procedures relevant to [identify any category not tested] because [state reasons for excluding any category from testing].

The management of [name of entity] is responsible for establishing and maintain-

Exhibit 13-1 (cont.)

ing an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention that relate to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted].

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

This report is intended for the information of the audit committee, management, and others within the organization and [specify regulatory agency or other third party].

The second additional report required is on compliance with laws and regulations that may have a material effect on the financial statements. The Statement defines material noncompliance as violations of laws or regulations that cause the auditor to conclude that the aggregation of misstatements—that is, likely misstatements, not just known misstatements—resulting from those violations is material to the financial statements. The report should provide positive assurance on the transactions tested and negative assurance on the untested transactions. Exhibit 13-2 is an example of a report on compliance when the auditor's procedures disclosed no material violations.

Exhibit 13-2 *Example Report on Compliance—No Material Violations Identified*

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and the *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements.

Compliance with laws and regulations applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of our audit, we performed auditing procedures designed to provide evidence about [name of entity]'s compliance with laws and regulations generally recognized as having a direct and material effect on the determination of financial statement amounts. However, it should be noted that we considered such laws and regulations as part of providing reasonable assurance that the financial statements are free of material misstatement; our objective was not to provide reasonable assurance about compliance with such laws and regulations.

The results of our auditing procedures indicate that with respect to the items tested [name of entity] complied, in all material respects, with those laws and regulations. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those laws and regulations.

This report is intended for the information of the audit committee, management, and others within the organization and [specify regulatory agency or other third party].

The auditor, based on the assessment of audit risk and materiality, may conclude that it is not necessary to perform tests of compliance with laws and regulations (for example, if the relevant transactions and balances were not material to the financial statements taken as a whole). Accordingly, the auditor does not provide positive assurance in the report. Exhibit 13-3 is an example of a report in such circumstances.

Exhibit 13-3 *Example Report on Compliance—Tests of Compliance Unnecessary*

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and the *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of our audit, we assessed the risk that noncompliance with laws and regulations generally recognized as having a direct and material effect on the determination of financial statement amounts could cause the financial statements to be materially misstated. Based on that assessment, we concluded that it was not necessary to perform additional auditing procedures designed to provide evidence about [name of entity]'s compliance with such laws and regulations. It should be noted that we considered such laws and regulations as part of providing reasonable assurance that the financial statements are free of material misstatement; our objective was not to provide reasonable assurance about compliance with such laws and regulations.

However, in connection with our audit, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those laws and regulations.

This report is intended for the information of the audit committee, management, and others within the organization and [specify regulatory agency or other third party].

When material noncompliance is identified, neither positive nor negative assurance is included in the report. However, the auditor reports material instances of noncompliance even if the misstatements have been corrected and the financial statements are not misstated. Exhibit 13-4 illustrates a report when the auditor identifies material instances of noncompliance.

Exhibit 13-4 *Example Report on Compliance—Material Noncompliance Identified*

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and the *Government Auditing Standards*, issued by the Comptroller General of the

Exhibit 13-4 (cont.)

United States. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements.

Compliance with laws and regulations applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of our audit, we performed auditing procedures designed to provide evidence about [name of entity]'s compliance with laws and regulations generally recognized as having a direct and material effect on the determination of financial statement amounts. However, it should be noted that we considered such laws and regulations as part of providing reasonable assurance that the financial statements are free of material misstatement; our objective was not to provide reasonable assurance about compliance with such laws and regulations.

Material instances of noncompliance are violations of laws or regulations that cause us to conclude that the aggregation of misstatements resulting from those violations is material to the financial statements. The results of our auditing procedures disclosed the following material instances of noncompliance.

[Include paragraphs describing the material instances of noncompliance noted.]

We considered these instances of noncompliance in forming our opinion on whether [name of entity]'s 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

This report is intended for the information of the audit committee, management, and others within the organization and [specify regulatory agency or other third party].

6. ADDITIONAL REQUIREMENTS APPLICABLE TO A SINGLE AUDIT

Governments receiving over $100,000 of federal financial assistance must have an audit in accordance with the Single Audit Act of 1984. A *major program* is defined by the Single Audit Act and by OMB A-128 as the larger of $300,000 or 3 percent of grant-funded expenditures for governments with up to $100 million of such expenditures. For governments with over $100 million of expenditures, OMB A-128 contains a sliding scale for determining major programs.

An audit in accordance with OMB A-128 (a single audit) has the following additional requirements. The auditor should plan and perform audit procedures to test compliance with both the general requirements of the *Compliance Supplement* for major federal assistance programs and the specific requirements of those programs. The auditor should also test compliance with the requirements relating to federal financial reports and claims for advances and reimbursements, for instance, test whether such reports contain information that is supported by the books and records from which the basic financial statements were prepared.

Matching requirements, levels of effort, and earmarking (for example, whether such limitations were met and whether the amounts used for matching were determined in accordance with OMB A-87 or A-122) should also be subjected to audit procedures.

As part of testing expenditures, the auditor should consider whether evidence obtained from the audit procedures performed in evaluating the validity, completeness, or valuation of expenditures charged to governmental assistance programs selected for financial audit purposes indicates noncompliance with applicable, specific requirements related to—

- *Allowability* of the cost as set forth in OMB A-87 cost principles (or, if applicable, equivalent state or local requirements) or in OMB A-122.
- *Eligibility* of the recipient of the expenditure to receive aid under the program. (This would apply only to social welfare programs.)

In addition, the auditor should select and test a representative number of expenditures charged to each major program.

A single audit also requires the issuance of several reports in addition to those for an audit in accordance with GAGAS. The first is an opinion on compliance with the laws and regulations that may have a material effect on each major program as well as a schedule of findings and questioned costs. Exhibit 13-5 is an example of an unqualified opinion report. Exhibit 13-8 at the end of this chapter illustrates a report qualified for a scope limitation, while Exhibit 13-9 illustrates a disclaimer of opinion. Exhibit 13-10 is a report qualified because of noncompliance. An adverse opinion for noncompliance is presented in Exhibit 13-11.

Exhibit 13-5 *Example Report on Compliance With Requirements for Major Programs—Single Audit*

We have audited the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of

Exhibit 13-5 (cont.)

Example is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, the standards for financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph. We also considered them in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

In our opinion, the City of Example, Any State, complied, in all material respects, with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1.

The second report is on compliance with certain laws and regulations, and a schedule of findings and questioned costs for transactions charged to nonmajor programs tested as part of the audit of the financial statements. An example of this type of report is presented in Exhibit 13-6.

Exhibit 13-6 *Example Report on Compliance With Requirements for Nonmajor Programs—Single Audit*

As required by the Single Audit Act of 1984 and Office of Management and Budget Circular A-128, "Audits of State and Local Governments," we have performed auditing procedures to test compliance with the requirements governing types of services allowed or unallowed; eligibility; and [describe any special tests and provisions] that are applicable to the following nonmajor federal finan-

Exhibit 13-6 (cont.)

cial assistance programs [list programs from which transactions were selected for testing] for the year ended June 30, 19X1. We performed these procedures in connection with our audit of the 19X1 general purpose financial statements of the City of Example, Any State, and with our study and evaluation of the City's internal control systems used to administer federal financial assistance programs, performed as required by the Single Audit Act and Circular A-128. Our procedures were substantially less in scope than an examination, the objective of which is the expression of an opinion on the City's compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed above. With respect to items not tested, nothing came to our attention that caused us to believe that the City of Example had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report]. We also considered them in our study and evaluation of the City's internal control systems used to administer federal financial assistance programs, performed as required by the Single Audit Act and Circular A-128, and this report does not affect our report on those internal control systems dated [date of report].

This report is intended solely for the information of the audit committee, management, and [specified regulatory agency or other specified third party].

The third additional report required by the Single Audit Act is a report on the supplementary schedule of federal financial assistance. The fourth report is on the internal control structure relevant to federal financial assistance programs.

7. IMPLEMENTATION ISSUES

7.1 Relation of the Statement on Compliance Auditing to SAS No. 54

SAS No. 54 *Illegal Acts by Clients*, states that illegal acts with a direct and material effect on the financial statements are to be considered irregularities and that the auditor, following the guidance in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* is responsible for applying audit procedures to provide reasonable assurance of detecting material errors and irregularities. The Statement on compliance auditing explains these responsibilities in greater detail for audits of governmental entities and of nongovernmental entities that receive financial assistance from a governmental agency.

7.2 Government Contracts

The Statement would be applicable to state or local governmental units or to nongovernmental entities that receive financial assistance from governmental agencies. A government contract for goods or services (for example, a city contract to a builder for construction that is part of a community development program) is not considered tobe "financial assistance." The Statement would not apply to the audit of the builder's financial statements; instead, SAS 53 on errors and irregularities and SAS 54 on illegal acts would apply, as they do for all audits in accordance with GAAS.

7.3 Not-for-Profit Organizations

Would the Statement apply to the audits of all not-for-profit organizations? The answer is no. It would apply only to those that receive direct financial assistance from federal, state, or local governments, or to those that receive financial assistance passed through from another entity. For example, a city receives a grant from a federal program and, as part of the efforts of this program, the city provides funds to a not-for-profit corporation. The Statement would apply to the audits of both the city and the not-for-profit corporation. However, the audit of a not-for-profit corporation supported entirely from private contributions would not be subject to the Statement's requirements.

7.4 Testing Related to the Davis-Bacon Act

This is one of the general requirements of the *Compliance Supplement*. The *Compliance Supplement* requirements apply when the entity must have a single audit because there is a major program (as previously defined) involved. The Davis-Bacon Act requires that laborers working on federal financial construction contracts be paid a wage established by the U. S. secretary of labor. For example, if a city hired a builder in connection with a major program, then the auditors of the city's statements should test disbursements to the builder for compliance with the Davis-Bacon Act.

7.5 Working Papers

In defining documentation requirements, the Statement refers to SAS No. 41, *Working Papers*, for guidance on the documentation of the procedures performed to evaluate compliance with laws and regulations. Note that the Statement on compliance auditing refers to SAS 55 for guidance on the documentation of the understanding of the internal control structure, as it pertains to compliance with laws and regulations.

7.6 No Reportable Conditions Report

Paragraph 17 of SAS 60 prohibits the auditor from issuing a report stating that no reportable conditions were noted during the audit. However, for audits in accordance with GAGAS, government auditing standards require the issuance of a report on internal control. What should the report say if no reportable conditions were noted? Exhibit 13-7 illustrates such a report.

Exhibit 13-7 *Example Report on the Internal Control Structure—No Reportable Conditions—GAGAS Audit*

In planning and performing our audit of the financial statements of [name of entity] for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [identify control categories].

Our consideration included all of the control categories listed above except that we did not perform tests of controls to evaluate the effectiveness of the design and operation of policies and procedures relevant to [identify any category not tested] because [state reasons for excluding any category from testing].

The management of [name of entity] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not

Exhibit 13-7 (cont.)

absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended for the information of the audit committee, management, and others within the organization and [specify regulatory agency or other third party].

8. SUMMARY

The Statement on compliance auditing would apply to audits of state or local governmental units or to audits of nongovernmental entities that receive financial assistance from governmental agencies.

In an audit of financial statements in accordance with GAAS (financial audit), the auditor should test compliance with laws and regulations that have a direct and material effect on the financial statements (except for the effect of disclosure of contingencies).

In an audit in accordance with GAGAS (GAO standards), the auditor should also issue reports on controls and on laws and regulations.

In an audit in accordance with OMB A-128 (a single audit), the auditor should test for compliance with the general and specific requirements of the *Compliance Supplement* for major programs; allowability and eligibility requirements for a representative number of transactions charged to major programs; matching, levels of effort, and earmarking requirements; requirements related to federal financial reports; and claims for advances and reimbursements. In addition, in a single audit, the auditor should issue the following reports in accordance with GAAS and GAGAS: a report on the supplementary schedule of federal financial assistance; an opinion on compliance with laws and regulations applicable to major programs; a report on compliance with laws and regulations applicable to nonmajor programs; and a report on controls over federal financial assistance.

Exhibit 13-8 *Example Report on Compliance With Requirements for Major Programs—Single Audit—Qualified for Scope Limitation*

We have audited the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of Example is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, the standards for financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards, the standards for financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

Exhibit 13-8 (cont.)

We were unable to obtain sufficient documentation supporting the City's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to the City's compliance with those requirements of Major Program ABC by other auditing procedures. We considered this limitation on the scope of our examination in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph. We also considered them in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the City's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed, the City of Example, Any State, complied, in all material respects, with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1.

Exhibit 13-9 *Example Report on Compliance With Requirements for Major Programs—Single Audit—Disclaimer of Opinion*

We were engaged to audit the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; elgibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of Example is responsible for the City's compliance with those requirements.

Exhibit 13-9 (cont.)

[Second paragraph of the standard report on major program compliance should be omitted.]

The management of the City of Example has refused to provide us with written representation that generally accepted auditing standards require us to obtain.

Because of the matters described in the preceding paragragh, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1.

Exhibit 13-10 *Example Report on Compliance With Requirements for Major Programs Single Audit—Qualified for Noncompliance*

We have audited the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of Example is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, the standards for financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

Our testing of transactions and records of Major Program ABC disclosed that the City did not comply with the laws and regulations which require that the City match the funds received from Major Program ABC. In our opinion, the City's matching of funds received from Major Program ABC is necessary for the City to comply with the laws and regulations applicable to Major Program ABC. We

Exhibit 13-10 (cont.)
considered this noncompliance in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph. We also considered them in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

In our opinion, except for those instances of noncompliance with the laws and regulations applicable to Major Program ABC referred to in the third paragraph of this report and identified in the accompanying schedule of findings and questioned costs, the City of Example, Any State, complied, in all material respects, with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1.

Exhibit 13-11 *Example Report on Compliance With Requirements for Major Programs—Single Audit—Adverse Opinion*

We have audited the City of Example, Any State's, compliance with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of Example is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, the standards for financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128, "Audits of State and Local Governments." Those standards and

Exhibit 13-11 (cont.)

OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

During the year ended June 30, 19X1, the City did not employ procedures to determine the eligibility of applicants for assistance under each of the City's two major federal financial assistance programs. Furthermore, as discussed in the accompanying schedule of findings and questioned costs, the City provided assistance under those programs to applicants who were not eligible to receive such assistance. In our opinion the determination of the eligibility of applicants for assistance under each of the City's two major federal financial assistance programs is necessary to administer each of those programs in compliance with laws and regulations. We considered this noncompliance in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph. We also considered them in forming our opinion on whether the City's 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those financial statements dated [date of report].

In our opinion, because of the noncompliance referred to in the preceding paragraph, the City of Example, Any State, did not comply, in all material respects, with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1.

Index

All citations in this index are to the chapter titles and chapter section numbers. Chapter titles have been abbreviated; abbreviations have been chosen to correlate as closely as possible with chapter titles. Following is a key to the chapter title abbreviations used in the index citations.

Chapter	*Index Abbreviation*
1. Accounting for Income Taxes	IT
2. Accounting for Cash Flows	CF
3. Employers' Accounting for Pensions	PEN
4. Accounting for Consolidations	CON
5. Accounting for Loan Origination Fees	LOF
6. The FASB Emerging Issues Task Force	EI
7. Overview of Other Statements and Technical Bulletins	OS
8. Errors, Irregularities, and Illegal Acts	E&I
9. Internal Control Structure	ICS
10. Improving Audit Effectiveness	AUD
11. Auditor Communications	COMM
12. Pro Forma Financial Information	PF
13. Compliance Auditing	COMP

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